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AN APPRAISAL OF THE INTERNAL AUDIT ORGANIZATION OF THE NAVY

WILLIAM J. BUSH

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William J. Bush

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by

William J. Bush
Lieutenant, Supply Corps, United States Navy

Submitted in partial fulfillment of
the requirements for the degree of

MASTER OF SCIENCE

IN

MANAGEMENT

United States Naval Postgraduate School
Monterey, California

1965

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This work is accepted as fulfilling
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IN
MANAGEMENT
from the
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ABSTRACT

Internal auditing was implemented by the United States Navy in 1951 as a means of management control over financial operations. During the fifties, industrial auditors began to review and appraise functional areas other than financial in order to provide a better service to management. The purpose of this study is to compare the roles internal auditors play in industry and in the Navy today. Additionally, the effectiveness of the Navy audit organization as a means of executive control is determined. The study reveals that Navy Audit is just as advanced in its operations as industry and that it is an effective means of control. The major problem facing Navy Audit's management in future years is the recruitment and development of personnel so that the demands of top Navy management will be fulfilled.

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CHAPTER I

INTRODUCTION

According to Henri Fayol, a classical management theorist, the principles of management are planning, organization, direction, coordination, and control. In his book of 1916, General and Industrial Management, Fayol describes control as "verifying whether everything occurs in conformity with the plans adopted, instructions issued, and principles established." Managers can rigorously follow the planning, organizing, directing, and coordinating principles in an attempt to be effective; but unless objectives are being fulfilled, the goals of the organization may never be reached. There are various means of control, e.g., budgeting, statistical analysis, standards systems, break-even analysis, internal auditing, and personal observation, available for management's utilization.

I. PURPOSE OF THE STUDY

The evaluation of internal auditing as a means of control in the United States Navy is the thesis of this paper. A review of internal auditing in the Navy and industry is made to determine the effectiveness of this control medium in the U. S. Navy and how it compares with the industrial concept of the internal audit function.

II. THE PROBLEM

From the time internal auditing began until the last decade, its primary objectives, both in industry and government, were to ensure compliance with rules and regulations, accuracy of financial records, and honesty in financially accountable positions. As organizations grew in size and management techniques became more sophisticated, internal auditors in industry began to conduct operational (management) audits in hopes of providing better service to management. The Federal government, especially the Department of Defense, has also become a very complex organization and its management techniques are becoming more sophisticated. Consequently, the question arises as to whether Navy Audit is keeping pace with changing times and adjusting to the demands of management. It is intended that this paper will provide the answer.

III. METHOD OF RESEARCH AND PRESENTATION

The research performed in order to compile this study consists of a review of historical information, current literature, and empirical data which were available at the U. S. Naval Postgraduate School and information received from the Auditor General of the Navy. The order of research and the presentation of the material in this study are essentially the same and are as follows:

1. A review of the available literature to determine the role internal audit plays in industry.

2. A review of the background and purpose of internal auditing in the Federal government and, especially, in the Navy.

3. A review of current staffing, operating costs, policies, and procedures within the organization.

4. A review of a sample of audit reports submitted to top management.

5. A summary and conclusion in each of the areas reviewed regarding the comparison of internal auditing in private industry and in the Navy, the effectiveness of Navy Audit as a means of control, and suggestions for improving the service provided by Navy Audit.

The subjects investigated in order to facilitate discussion of the above are objectives, organization, personnel, and audit reports. An additional section is included on the various types of audits conducted by the Navy.

IV. PREVIOUS RESEARCH

A thesis entitled "Internal Auditing in the United States Navy--A Search for Improvements" was written by Lieutenant Commander Dick H. Francisco, Supply Corps, United States Navy, in 1964 at the Naval Postgraduate School. Commander Francisco's thesis is an attempt to determine the reasons for local management's nonacceptance of internal audit service. He concludes that it is due to: (1) the inclusion of findings in audit reports for which corrective action is already being taken, (2) the inclusion of minor items in the reports submitted to top management, (3) a lack of human relations used by the auditors, and (4) the predominance of compliance type of findings that seem to place local activities on report rather than providing a service.

This acceptance aspect is not examined in view of Commander Francisco's contribution, but his conclusion concerning compliance type of findings is challenged in a later chapter since it appears to be a necessary part of the audit function. Although the two papers are different in scope, the necessity for overlap exists at certain points in order to provide continuity in the present discussion. However it is felt that this is kept to a minimum.

CHAPTER II

INTERNAL AUDITING IN PRIVATE INDUSTRY

Before reviewing the development of internal auditing in the Federal Government, particularly the Navy, and examining the current philosophy, policies, and procedures of the Navy Internal Audit organization, an examination of internal auditing as a tool of industrial management serves to add balance to the overall appraisal of internal auditing in the Navy. Hopefully, a determination of whether Navy internal auditing is lagging behind that of industry, is keeping pace, or is in the forefront will result from this review.

In order to determine what industrial internal auditing entails, a review of the available literature and surveys performed by various groups, e.g., the Institute of Internal Auditors, is conducted. Although much of the literature is written by theorists, an attempt is made to obtain a cross-sectional viewpoint by gathering writings of people engaged in commercial activity, whether internal auditors, accountants, or otherwise. It is hoped that this approach will present a balanced viewpoint of the industrial concept of internal auditing.

The areas reviewed in this chapter are the purpose and scope of the internal audit function, the organization and personnel required to fulfill this function, and the resultant audit reports. Since methods and techniques vary depending on the type of audit, any review of the manner in which they are

conducted would be a monumental task and entail a voluminous report. It is believed that this is beyond the scope of this research paper.

I. OBJECTIVES AND SCOPE

Rather than define the purpose of internal auditing at the outset, it is suggested that a review of its evolution from public accounting and its relationship to internal and management controls would serve to gain a better perspective of its operation in the business community today. After this background is developed, the new concept of management audit is discussed. Finally, a definition of internal auditing, as utilized by industry today, is developed.

External Auditing. The need for outside auditors became evident in the 1800's when business began to take the form of organized ventures rather than the formerly predominant proprietorships. Once a businessman started to employ others to carry out the diverse functions of the enterprise, he was required to ensure himself that the company's assets were protected against fraud and embezzlement. The businessman's answer to this problem was the Certified Public Accountant--the external auditor. In the early days, the primary responsibility of the public accounting profession was the prevention and detection of fraud.[1]

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[1]Robert H. Montgomery, Auditing Theory and Practice, (New York: The Ronald Press Company, 1918), p. 8.

As the business community grew in size and advanced its methods of production, selling, and accounting, various groups became involved in its operations. Stockholders and creditors became important sources of capital; the government became interested in companies when the anti-trust laws were passed in the late 1800's and also as a source of tax revenue after the turn of the century. All of the interested parties demanded assurance that financial conditions, as reported by the company, were correct. Again, the external auditor rose to meet this challenge by appraising the financial condition of the companies. Today, the certification that the financial condition is, or is not, correctly stated and the accounting procedures of the company are, or are not, in accordance with "generally acceptable accounting practices" appears on the published financial statements of all publically held businesses.

Although the early literature is replete with definitions of auditing, two such definitions, one of a general nature and the other specific, will suffice to authenticate the above statements. At that time, auditing was defined as:

> . . . the art of reviewing the work incident to the record, compilation and presentation of the facts concerning financial transactions.[2]

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[2]John Raymond Wildman, Principles of Auditing, (Brooklyn: The William G. Hewitt Press, 1916), p. 2.

. . . ascertain /ing/ the actual financial condition and earnings of an enterprise for:

(a) Its proprietors (partners or stockholders),
(b) Its executives (managers, officers, or directors),
(c) Bankers or investors who are considering the purchase of securities,
(d) Bankers who are considering the discounting or purchasing of its promissory notes,

. . . /and/ the detection of fraud or errors.[3]

With the prospects of business investment becoming more attractive than ever and the continuous advancement of our technology, companies have maintained a steady growth until today many industrial complexes cover the globe with factories and distribution centers. Commensurate with these characteristics of growth was the inability of chief executives to maintain immediate control of day-to-day operations; therefore, specialization and delegation of authority were required for efficient operation. As top management became more removed from the operational phases of their companies, the means of control and reliability of feedback information took on greater importance. Executives had to be sure that their plans and policies were being fulfilled so that the organization's objectives would be accomplished. Their decisions were based primarily on information emanating from their diverse organizational units--thus, assurance that this information was correct and reliable was necessary. As an added inducement to providing accurate information, the government's increasing demand for reports made it mandatory for a corporation to ensure that its information was correct.

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[3]Montgomery, op. cit., pp. 10-11.

These new responsibilities of executive management and the need for a link between management and operations were aptly expressed by Victor Brink in 1941 when he stated:

> The significance of these various responsibilities on the part of corporate management is that all of them necessitate a more thoroughgoing knowledge of the internal affairs of the organization. Executive action must be based on data which are reliable and properly analyzed. The data at the same time must be studied in conjunction with the processes to which they relate and as a guide to them. It is only in this way that management can bridge the gap which has developed in modern corporate enterprise between management and the detailed current operation of the organization. And it is these needs which increase the importance of any management tool, such as internal auditing, which is designed to verify and appraise in a constructive manner.[4]

It became apparent that the annual review of a company's financial position by external auditors did not give management constant assurance of reliable information. As a result, companies began to establish auditing organizations internally. The internal audit groups were usually responsible for verifying the lower echelon's compliance with policies and procedures in accounting and financial areas and the accuracy of figures as reported to top management. As this new managerial tool began to take hold, internal auditors also started to evaluate the financial policies and procedures of their companies. One definition of an internal auditor's responsibilities stated in 1941 is as follows:

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[4]Victor Z. Brink, Internal Auditing, (New York: The Ronald Press Company, 1941), p. 8.

1. The ascertainment of compliance with the organization's rules, procedures, and policies of an accounting and financial nature and their related aspects.

2. The conservation of the organization's resources and general protection of its interests with respect to assets, liabilities, revenues, and expenditures, and their related implications.

3. The verification of accounting and financial data in a broad sense, together with effective analysis of them.

4. The appraisal of existing rules, procedures, and policies relating to accounting and financial and associated activities, together with constructive recommendations which are directed toward the improvement of general company welfare.

5. The training and encouragement of personnel, together with the provision of such circumstances and conditions as are most conducive to their welfare.

6. Other services to management of a direct nature in the way of providing an effective means of contact with field operations and an impartial reporting agency; the provision of personnel for executive positions; and the furthering of the efficiency and economy of outside audit.[5]

Inherent in the appraisal of financial policies and procedures and the review of resource protection is the analysis of methods of internal check and control. During the formative days of internal auditing, there was much confusion between the terms internal checks and controls and audits. In order to prevent any confusion here, a distinction between them is necessary.

Internal Check and Control. An illustration of the confusion in terminology is provided by Brink when he refers to a speech by W. M. Hawkins given to the Detroit Controllers Group in 1938. Hawkins is quoted as saying:

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[5]Ibid., p. 38.

> The system of internal audit, also referred to as /the/ system of internal check, system of internal control, and system of checks and double checks, is of vital consideration to every business.[6]

Brink goes on to say that "this address was entitled 'Internal Audit--An important function of the Controller's office,' but it dealt almost entirely with the methods and practices of internal check--not internal audit."[7] One explanation for this confusion in terms is the English language itself. Auditing is defined as "an official examination and verification of accounts and records."[8] In the early days of accountancy, the financial systems provided for checks such as the verification of dealers' bills and the distribution and accuracy of payrolls prior to payment. These functions were called preauditing, and those who performed the functions auditors. Also, after-the-fact auditing, a postaudit, was part of the financial systems. An example of postauditing is the monthly reconciliation of bank accounts--although a routine operation of the accounting system, the term postaudit was used to describe this function. Unfortunately, these terms have remained part of our vernacular and even today a misconception of the meaning of internal checks and audit exists.

Before providing a definition of internal check and control, the distinction, if any, between check and control should be made. In

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[6] Ibid., p. 15.

[7] Ibid.

[8] C. L. Barnhart, The American College Dictionary, (New York: Random House, 1963), p. 81.

reviewing the literature, little distinction is made between them. Essentially, most writers use the two terms synonymously. It would seem that internal checks are individual components, and internal control refers to the whole system of checks and balances. One definition of internal control is:

> . . . the scientific distribution of duties and responsibilities which is made by an organization in order to establish a system of checks and balances so designed that the activity of one officer or employee independently performing his own prescribed work will check automatically, continuously, and with little or no duplication, the work of another or others. The result of this control is that assets will be safeguarded and all transactions will be fully and accurately reflected in the accounting or other records of the organization.[9]

This idea of internal control is the assignment of duties in such a manner that an automatic check is provided to prevent fraud or embezzlement and to ensure the accurate recording and reporting of financial information. The theory behind an internal control system is excellent; however, in reality, problems arise that may prevent the attainment of complete control. First, the size of the company may prohibit the separation of duties and responsibilities. Conceivably, the same employee could be accountable for a transaction from beginning to end. Second, the nature of the transaction may prevent division of responsibility, e.g., sales clerks in retail stores who hold the merchandise, authorize the sales, and receive the

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[9]John B. Thurston, Basic Internal Auditing Principles and Techniques, (Scranton, Pennsylvania: International Textbook Company, 1949), p. 8.

payments.[10] Third, the nature of human beings to make errors, intentionally or otherwise, prevents the system of internal control from reaching perfection. Consequently, the requirement for some method of control where internal control is not feasible or where it breaks down is paramount. To meet this need, most companies turn to their internal auditors. As Thurston states:

> Internal auditing performs a dual role in the system of internal control: (1) Internal auditing is necessary to assure the proper functioning of the system of internal control, to determine its continuing adequacy, and to disclose promptly the possibility of improvements or economies, or the need for them; and (2) internal auditing is necessary in order to establish control over transactions which must be left exclusively, or almost exclusively, to one employee or department; and to establish control over transactions where it is impracticable to provide the usual internal checks and balances.[11]

The conclusion drawn from the above discussion is that internal auditing is not an integral part of the internal control system; it is not a repetitive part of the routine. Instead, auditors review the system to determine its effectiveness and efficiency and suggest improvements if required. Since internal auditing is beyond the scope of an internal control system, it is suggested that the relationship between management control and internal auditing be reviewed to determine the extent of this association.

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[10]David R. Anderson and Leo A. Schmidt, Practical Comptrollership, (Homewood, Illinois: Richard D. Irwin, Inc., 1961), p. 66.

[11]Thurston, op. cit., p. 17.

Management Control. As mentioned previously, the business community is constantly advancing its methods of operation. In order for a company to survive in our competitive economy, advancement in the field of management is as necessary as in scientific and production areas. One such advancement is the establishment of managerial planning and control systems, the basic elements of which are stated as follows:

1. Objectives or ends to be accomplished.
2. Plans, policies, and procedures; or an outline of how, when, and by whom the objectives are to be attained.
3. Premises, or assumptions, as to future facts and conditions interpreted in the light of current actualities.
4. Standards, or yardsticks, for measuring the results achieved in carrying out the plans, policies and procedures.
5. Appraisal and evaluation of results.[12]

The most significant aspect of this description is the interdependency of each element. Only when each element is effectively accomplished is there any control, and a breakdown in any one results in the loss of managerial control. For example, if policies and procedures are not optimal for a given function, top management may find it very difficult to obtain desired objectives.

What is the relationship of internal auditing to managerial controls? Is it a part of management control or divorced from it? Without much thought given to the question, it appears that internal auditing is associated very easily with the appraisal and evaluation element. However, in defining

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[12]Frank A. Lamperti and John B. Thurston, Internal Auditing for Management, (Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1953), pp. 8-9.

internal auditing, Lamperti and Thurston state that the auditing function entails an appraisal of management controls, among other things. More precisely, they state:

> Internal auditing is a series of processes and techniques through which an organization's own employees ascertain for the management, by means of first-hand, on-the-job observation, whether (a) established management controls are adequate and effectively maintained; (b) records and reports--financial, accounting and otherwise--reflect actual operations and results accurately and promptly; and (c) each division, department or other unit is carrying out the plans, policies, and procedures for which it is responsible.[13]

Although this is only one definition of internal auditing, most of the definitions given in the literature concur that it is the internal auditor's responsibility to evaluate the effectiveness of control systems. With this in mind, it appears that internal auditing operates outside the framework of managerial controls, since it evaluates the adequacy of the latter.

The well-known analogy for this situation is the thermostatic control of heat in the home. The thermostat operates in the same manner as internal controls in an organization--automatically. However, if the thermostat obtains some slippage and does not operate at optimum, the inhabitants can make an adjustment to obtain the desired heating plan. This is the same function that management controls provide in industry--on the spot adjustments to achieve desired objectives. If the homeowner is a practical and sensible person, he periodically obtains the services

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[13] Ibid., p. 163.

of an experienced furnaceman to examine the furnace and thermostatic control system and evaluate their effectiveness. This part of the analogy can be associated with the services of the internal auditor. Within the foregoing framework of management control and internal auditing as defined, it is concluded that internal auditing is not a means of management control, but a higher level of control.

The above definition and analogy give rise to a very important question: how far can internal auditors go in their appraisal of controls, adherence to plans and policies, and so on? Is the furnaceman knowledgeable enough to evaluate a thermostatic control system? Since internal auditing is an outgrowth of public accounting, it has always been associated with the field of accountancy. The people employed in internal audit organizations have been educated predominantly in accounting and auditing theory. Are these people qualified to examine aspects of a business other than the financial and accounting areas? Until recently, the answer to this question would have been, for the most part, negative. Even the "Statement of Responsibilities of the Internal Auditor", as developed by the Institute of Internal Auditors in 1947, is vague in this regard. It states:

> Internal auditing is the independent appraisal activity within an organization for the review of the accounting, financial, and other operations as a basis for protective and constructive service to management. It is a type of control which functions by measuring and evaluating the effectiveness of other types of control. <u>It deals primarily with accounting and financial matters but it may also properly deal with matters of an operating nature</u>. /Italics not in the original/.

> The overall objective of internal auditing is to assist management in achieving the most efficient administration of the operations of the organization.[14]

The statement itself may not appear to be a weak stand on internal auditing's applicability to areas outside accounting, but when compared with the Institute's revised statement in 1957, it can be seen that the ambiguity disappears. The significant part of the revised statement is as follows:

> Internal auditing is an independent appraisal activity within an organization for the review of accounting, financial and other operations /italics not in the original/ as a basis for service to management. . . Hence the internal auditor should be concerned with any phase of business activity /italics not in the original/ wherein he can be of service to management--subject only to his own competence to appraise the particular matters under review.[15]

The 1957 statement is indicative of the changing scope of internal auditing that commenced in the middle fifties and continues today. The areas into which the internal auditor can delve seem unlimited. As an example, the President of the Minnesota Mining and Manufacting Company states that:

> . . . our auditing groups have felt free--even under obligation-- to appraise and report upon any area of our organization. . . Really, the only limitation is in the ability of the auditor to come up with helpful ideas, and to present them in a manner which will make other groups willing to accept them.[16]

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[14]James T. Johnson and J. Herman Brasseaux, (ed.), Readings in Auditing, (Cincinnati: South-Western Publishing Company, 1960), p. 313.

[15]Ibid., pp. 313-314.

[16]H. S. Arrowood, "The Modern Concept of Internal Auditing," The Internal Auditor, XX (Summer, 1963), p. 20.

The trend of internal audits to cover areas removed from accounting and finance meant that the auditing profession had to find a term that is descriptive of this new aspect of auditing. The terms "operational" and "management" were coined by the auditors; however, the latter seems to have gained prevalence in the last few years. The following section attempts to determine what a management audit entails.

Management Audit. Although auditing theorists refer to the auditing of management controls and management audits in their writings, they generally provide only procedures for financial auditing. Similarly, the articles of businessmen fail to describe what really constitutes a management audit and, as a result, information concerning the real meaning of management audits is very scarce. At the risk of being insular, the discussion in this section and others is based primarily on readings from one book The Management Audit, written by William P. Leonard in 1962, and the article concerning auditing in the Minnesota Mining and Manufacturing Company previously cited.

Auditing has always been associated with accounting and financial aspects of a business. Heretofore, a review of the financial position, an appraisal of internal and management controls as they relate to financial matters, and the detection and prevention of errors and fraud were considered sufficient in fulfilling the internal auditor's responsibility to management. As the economy became more complex, growth of companies continued, and resources became scarce, some firms realized that existence

depended on remaining modern in all phases of its operations--including both line and staff functions. Management was aware that it must recognize weaknesses in the organization before severe consequences occurred, alternative methods of improving weak conditions, and the causes of unsuccessful, as well as successful ventures. Progressive managers realized that to remain on top of their vast empires, an organized review and appraisal system was required. As Leonard points out, this means more than:

> . . . merely a review and appraisal of traditional reports such as comparative profit and loss statement, balance sheets, and operating ratios. It means reviewing and evaluating the plans and objectives, the organizational structure, policies, systems, procedures, methods of control, human and physical facilities, standards of performance, and the measurement of results.[17]

Leonard envisions a management audit to cover the total scope of any activity, be it a complete organization, division, or department. There is no emphasis given either to financial matters or to other areas, but only to the totality of the unit and its interrelated functions of planning, organizing, operating, and controlling, and the results produced. The factors to be considered in the review and appraisal of an organizational unit are:

> . . . the economic outlook, the adequacy of the organizational structure, compliance with policies and procedures, accuracy and reliability of controls, adequate protective methods, causes for

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[17]William P. Leonard, The Management Audit, (Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1962), pp. 23-24.

variances, proper utilization of manpower and equipment, and satisfactory methods of operation.[18]

It is noted that some of these factors are similar to those mentioned previously by other authors, e.g., compliance with policies and procedures, accuracy and reliability of controls, and adequate protective methods. It must be emphasized that not only do the auditors accomplish the above, but they also evaluate the effectiveness of the organizational structure in relation to its goals, the effective use of its resources, and its methods of operations. Although much of the previous literature made references to "other" areas of review, Leonard has succeeded in defining what they may include. It seems obvious to conclude that Leonard's description of an audit is of a much broader scope than heretofore provided.

As a practical example of the broadening scope of auditing, the following excerpts from an article by the General Auditor of the Minnesota Mining and Manufacturing Company are provided:

> He /the internal auditor/ is concerned, of course, with the accuracy of accounting data, . . . appraising the usefulness of all financial information being assembled for management, . . . he still reviews internal controls because these controls are in effect the metabolism of a modern business . . . This review of controls involves both their measurement to see that they are working in the manner required and their evaluation to see whether they are weak, adequate or excessive. . . if he does his job well, the auditor will select and evaluate information

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[18] Ibid., p. 35.

> as though he were the owner or manager of the business involved. . . This brings us to the fringe of new areas in modern auditing. . . . More and more, the modern internal auditor is examining and analyzing the reported results of operations. This analysis requires an understanding of the objectives of those operations and an assessment of actual production in relation to these objectives. . . . He is free to question procedures which he feels have "missed the mark." And the ultimate purpose of these procedures, we must always remember, is to serve the customer in a manner that produces the desired profit. The act of examining company policy may imply a questioning of a management decision. But management wants to know and must know, whether a policy is working as intended. If not, why not? And if a policy is faulty, is there another one that will work better? . . . Some of the diverse areas we have audited . . . are the audio-visual department, the print shop, the aviation department, the office supply department, the company's surplus property, the company store, and many others. . . . Engineering is another area in which we are concerned. Engineering normally spends very large sums of money. Management is vitally concerned with how the hard-earned profits of past operations are spent on new capital additions. . . In auditing such standard organizational units as factories, sales branches and subsidiaries, the modern internal auditor also penetrates more and more into non-financial areas. For example, his analysis of production reporting may lead him to evaluate aspects of manufacturing procedures. His analysis of inventories may lead to recommendations on warehousing practices. His analysis of order processing may spark new sales policies that make the selling job more effective and more profitable.[19]

Although this is the only available definitive description of internal auditing as practiced in industry, it may very well be representative of the role internal auditing plays in the modern business community. In view of all that has been said, it seems evident that internal auditors provide a vital service to management and have the increasing responsibility

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[19]Arrowood, op. cit., pp. 15-18.

to review all areas of business, rather than merely financial activities.

Since many definitions of internal auditing have been given and the recent trend to management auditing tends to suppress a few basic principles, the author feels obligated, as a summary, to define internal auditing as it exists, or at least should exist, in private industry. Hopefully, the definition includes all the more important aspects of this section as they relate to internal auditing.

Internal Auditing Defined. Internal auditing is a staff function within an organization that provides a service to management. This service consists of ensuring management:

1. of compliance at all levels with
   (a) plans, policies, and procedures,
   (b) internal and management control systems;

2. of the feasibility and/or effectiveness of
   (a) objectives in relation to environmental conditions,
   (b) plans and policies in relation to objectives,
   (c) procedures and control systems,
   (d) protection and utilization of resources
   (e) capital investments;

3. that information concerning all aspects of the business is accurate and reliable.

Finally, upon completion of their reviews of any given aspect of the business, the suggestions of alternative solutions to management concerning areas that are inefficient or detrimental to the organization's goals are a most important responsibility of the internal auditor.

II. ORGANIZATION

Although the previous section represents the bulk of this chapter, it is essential to develop the real meaning of internal auditing. However, this and the following three sections do not necessitate such a prolonged discussion, since most of the literature is similar regarding the topics discussed. The topic of organization is presented with respect to placement of the internal audit group in the total organization, and its own organizational structure.

Placement Within the Organization. Before deciding where the audit group is located within the total organization, the decision to establish an audit department, section, or unit must be made. Probably the most influential factor in this decision is the size of the company. If it is small, the return in relation to the cost involved does not warrant establishing an audit group to perform the functions required in the modern concept of auditing. Small companies can receive adequate information from their public accountant's review and their own constant vigil over operations. The larger companies present more problems, and the decision becomes more complicated. The executives must ask themselves several questions when deciding the issue. Consideration must be given to the extent of decentralization and diversification of the company's functions, the number of employees, the adequacy of internal and management control systems, and the desire of management to be assured

that its plans, policies, and procedures are the most effective and are being carried out efficiently.[20]

With respect to the last consideration, the effectiveness of the auditing function and its value to management are very much dependent on the attitude of top management. If the auditing function is established merely because other reputable firms have such groups, it is unlikely that any real service will be provided except possibly the verification of financial statments and accounting reports. In discussing this problem, Lamperti and Thurston state:

> The Survey indicates that there are some companies where the activities of the internal auditors are restricted to verifying the accuracy of accounting and financial statements and reports. In virtually every instance these same companies report that their respective managements are not very much interested in the findings of their auditors nor very prone to examine their recommendations carefully and sponsor the implementation of those accepted.[21]

The survey cited represents a joint effort by the authors and the Institute of Internal Auditors to determine the internal audit practices of leading corporations. One hundred and thirty-three corporations are included in this survey and represent a cross section of all types of industries.

As an example of management's positive attitude, reference is again made to the statement of the President of the Minnesota Mining

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[20]Lamperti, op. cit., pp. 181-182.

[21]Ibid., p. 184.

and Manufacturing Company. The acceptance by that company's top management of internal auditors' reviewing all areas of the business activity is indicative of their support. Without this support, internal auditors are severely limited in the service they can provide.

In regard to the official to whom the head auditor reports, reference is again made to surveys that have been conducted--one reported by Victor Brink in 1941 and the other, the Lamperti-Thurston survey. Brink's survey consists of inquiries made of 119 corporations, of which 57 had internal audit organizations, and data released by the National Association of Cost Accountants in 1939. At that time, the officials to whom chief auditors reported were as follows:[22]

	BRINK	NACA	TOTAL
Comptroller	25	38	63
Treasurer	9	16	25
President	4	19	23
Vice-President	4		4
Misc.	9	28	37
No answer	6		6
	57	101	158

The Lamperti-Thurston survey of 1953 reveals that more than half of the chief auditors report to the Comptroller. However, they also state:

> Nonetheless, the survey does indicate a trend away from the comptroller and treasurer towards a financial or executive vice-president or higher. This is only a trend and may or may not be indicative of the future. The majority still do report to the comptroller or to the treasurer.[23]

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[22]Brink, op. cit., p. 48.

[23]Lamperti, op. cit., p. 185.

If there is a trend away from reporting to comptrollers, this may be explained by the movement away from the predominantly financial audits into other functional areas. Some companies may feel that reporting to an executive of a higher level is necessary. However, the Lamperti-Thurston survey reveals that:

> None [auditors reporting to comptrollers] believed that he was restricted in any way because of reporting to the comptroller. The majority opinion was that the comptroller or treasurer is more cognizant of the accounting and financial problems which still make up the greater part of the internal auditor's field of interest. The work of the comptroller or treasurer is not confined strictly to accounting and financial matters; he is regarded as an executive of the company and therefore, can be helpful in expanding auditing effort into new areas wherever necessary.[24]

As evident from the foregoing, there is no general consensus regarding the recipients of the chief auditor's reports. There is agreement, however, that he should be in the inner circle of top management. In this manner, information of significant nature will find its way to the appropriate level of the organization.

Another issue that has always been agreed upon is that of independence. The literature is replete with statements concerning this matter and one will suffice as representative:

> The function should be as entirely independent as possible of pressure from particular groups in the enterprise. The greater the independence, the more freedom to work effectively. Pressures will be far fewer and far less violent the higher up in the organization the function is placed. Another reason why the function should be as close as possible to the top executive lies in its value in effectuating management methods and

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[24] Ibid., pp. 391-392.

> performance. Many organizations have assigned the responsibility to a member of the top executive management team, but in recent years, the trend has been toward the top executive.[25]

Although Leonard's opinion that management auditors should report to the chief executive may be disputed by many, he does point out the reasons for independency. The chief auditor holds a staff position and should not be responsible to line managers. He must be outside the realm of pressures that might be exerted by those whose operations are being analyzed.

Once the determination is made by an organization to have an internal audit group, management must provide its full support and place it in such a position within the total organization that will ensure independence and status as a management tool to receive all the benefits that the group can provide.

Structure of Internal Audit Organization. Since the structure of the audit organization varies with every company, no attempt is made to define an optimal structure or to find a consensus of opinion on the matter. Instead, factors affecting the size and structure of an internal audit organization are noted and the advantages and disadvantages of decentralization (most prevalent type) discussed.

Some of these factors are the same as those considered when deciding on the usefulness of an audit group to the organization, i.e.,

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[25]Leonard, op. cit., p. 77.

decentralization, diversification, number of employees, and control systems present in the company. Probably the most influential aspect of the audit organization's structure is that, if decentralized, there may be a tendency to operate the audit group in the same manner. There are advantages and disadvantages to a decentralized audit operation. Some of these are:

Advantages. . .
- Less traveling and shorter intervals away from home.
- Greater familiarity with operations under review.
- Reduced traveling costs.
- Possibility of more frequent audits and reduction in length of period covered by each audit.
- Closer acquaintance with those being audited, resulting in the increased thoroughness of personnel studies.

Disadvantages. . .
- Restricted field of work and repetitive nature of audits could lead to taking too much for granted and only superficial audits.
- Need of frequent rotation of auditors from one zone or district to another for diversification and training.
- Increased problem of communications, supervision and coordination.[26]

The problem of choosing the best organizational structure is left to management and should be made in relation to the service that can be most helpful in fulfilling its responsibilities. Of even more importance to management than the structure of the auditing unit is the type of people employed--without competent personnel in the auditing group, the best organization in the world will be nonfunctional.

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[26]Lamperti, op. cit., pp. 190-191.

III. PERSONNEL

Once the internal audit organization is established and has top management support, the audit group, in return, must provide the best service possible. The quality of service to management is directly related to the capability of the audit personnel.

Personal Qualifications. The educational background of auditors generally consists of accounting and auditing theory with other related business courses. These are usually economics, finance, marketing and statistics; additionally, most undergraduate students are required to take several nonbusiness courses, e.g., psychology, sociology, and literature. As the scope of internal auditing has expanded into nonfinancial areas, many people believe that auditors must become knowledgeable in areas such as industrial management, methods engineering, management philosophy, scientific control of inventory, and industrial relations. Conversely, some express apprehension over the increased emphasis on formal education in the areas mentioned above. For example, Frank Lennon, the General Auditor of Pure Oil Company, states:

> . . . I firmly believe that within the framework of Management type of auditing there will always be for those with the initiative to dig and discover and who possess the good judgment to separate the wheat from the chaff, many opportunities to be of greater service to management in their review and appraisals, so that it will not be necessary for them to branch into the field of industrial management, engineering, economic planning, marketing research, etc., in order to maintain a proper place in their company's organizational structure.[27]

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[27] Frank Lennon, "Where Are We Going As a Profession;" The Internal Auditor, XX (Winter, 1963), p. 18.

Although Mr. Lennon's beliefs are applicable to gifted individuals, it appears that today's world of specialization demands more than the initiative and good judgment of the majority to provide the service expected by management. The decision to employ men educated and experienced in these other areas is dependent on the individual firm and the type of audit service required. Many firms believe that their auditing function is of the management or operational type, but, in reality, it is merely an audit of the financial aspects of operating or staff departments. Under these circumstances, there is no need for personnel experienced in specialized areas. On the other hand, if the auditors actually review and appraise the effectiveness of physical production standards, marketing policies, or inventory policies and systems, the need for personnel with full understanding and appreciation of the technical aspects of these areas are required.

The one common discipline that all writers stress as of utmost importance to the auditor is communications. Whether talking to local or top management, the auditor must be able to express his views clearly and concisely. The ability of the auditor to communicate is again emphasized in the section of this chapter on Audit Reports.

All these formalized qualifications are necessary in an auditor, but just as important are personal characteristics, not the least of which is tact. When an auditor is reviewing and appraising work performed by others, his ability to get along with people is very important. If he maintains a

"policeman" attitude, it is unlikely that he will receive cooperation during his study or in implementation of corrective action. The auditor who solicits the help of the personnel around him in reviewing a situation and asks for their suggestions in matters of improvement will usually provide better service to management. Another trait of the good auditor is that of imagination. Many audit organizations provide programs with specific steps to be followed in examining a particular area, but when the auditor adheres to the program so closely that his thoughts do not go beyond it, the audit organization is losing in its attempt to provide better service to management. The auditor cannot be bound by tradition; he must take a broad management outlook on all he examines. Only by having people with broad vision and imagination will the audit organization be safe from stagnation. Sound judgment is also a necessity for an auditor. His ability to review a situation, obtain and analyze the important facts, and reach a conclusion is of paramount importance in providing the best service. Now that some of the qualifications of auditors have been discussed, a look at the sources from which an audit organization may obtain its personnel, and the means of development, is in order.

Source and Development of Personnel. The two broadest categories of sources of personnel for any organization are "within" and "outside" the organization. Most of the literature indicates that companies attempt to obtain personnel primarily from within the organization. The majority of those recruited outside are college graduates who are necessary to maintain

the overall manning level of the audit organization. There has been a trend in recent years to utilize the internal audit unit as a training ground for future executives. Some companies place potential executives in the audit unit to provide them with an overall view of the organization's operations that will assist them in later years. In some cases, the potential executive is being groomed for top financial positions; in other cases, there is no particular functional area for which he is being developed, except general executive positions.

After coming into the audit organization with the necessary qualifications, audit personnel must strive constantly to increase the quality of their output. This means that a continuous personal improvement plan should exist, whether provided by the firm or by the auditor himself. Very few organizations provide the financial means for advanced education with the possible exception of the scientific fields of study; therefore, improvement of the auditor's knowledge is left to his own initiative and drive. Although constant self-improvement is always encouraged, proper recognition must be given to employees who actively pursue further education and other forms of betterment.

One method used by some companies to improve the quality of the audit work is that of periodic seminars conducted by the audit managers. Through the use of these seminars, exchange of ideas is encouraged with a resultant broadening of the employees' knowledge. The rotation of auditors among different localities and types of audits is also used by all

companies to facilitate the transfer of ideas and prevent the auditor from becoming overfamiliar in an area and, quite possibly, complacent.

For the audit organization to provide management with the information it desires, it is imperative that the audit personnel be of the highest caliber. A continuous program of self-improvement must be demanded if auditors are to stay abreast of changing developments in and outside their own organization. With high standards of employment and constant personal improvement, the audit organization has a better chance to fulfill its service to management in an efficient manner.

IV. AUDIT REPORTS

The importance of audit reporting is stressed heavily by all writers in the field of auditing as well as many others in the general field of information reporting. For the auditor, the audit report serves two purposes: first, it represents his means of communicating to top management the results of his labors; second, it represents a selling instrument through which the auditor presents his ideas for improving the organization's operations. Except in very small companies or in confidential matters, the reporting process consists of written reports to top management and oral discussions with local management. This section examines the preparation of the audit report, discussion of findings with local management, distribution of the report, and follow-up action.

Preparation of Report. Any report to management should be brief, clear, logical, well organized, and factual. As Lennon of the Pure Oil Company states:

> Auditing from a management viewpoint will give proper recognition to the fact that an audit report is not a novel, nor is it a medium to extol the knowledge and virtues of an auditor. This kind of auditing will take into account that the individuals receiving them are normally concerned with discharging their responsibilities, and that their interest in them is primarily related to how such reports will aid and assist them in administering and controlling the functions for which they are responsible. They should not be, and I am sure are not, interested in long dissertations on any subject; nor, on the other hand, with incomplete presentations which leave them ignorant of significant facts concerning the subject matter.[28]

The audit report should be of such caliber that the executive reading it can reach a decision on the matter without hesitation or apprehension. In writing the report, a few points that should be kept in mind are:

1. Take one finding or comment at a time and exhaust every possibility before going on to the next.
   - 1.1. Assemble all of the facts and data bearing on the situation.
   - 1.2. Classify and analyze them.
   - 1.3. Formulate a corrective program.
   - 1.4. Recommend steps for implementation.
2. Write it in language which cannot be misunderstood.
3. Eliminate all unnecessary words and details.
4. Present each step in your story in logical sequence.[29]

The ability of the auditor to present a well organized report is of utmost importance. Although the outline of the report again depends on the desires and habits of an individual management, most of the literature reflects a similar outline to that given by Leonard which is as follows:

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[28] Ibid., p. 16.

[29] Lamperti, op. cit., p. 286.

I. Purpose and Scope
II. Facts of Major Importance
III. Matters Discussed with Superivision
IV. Current Practices (Detail)
V. Discussion or Comments
VI. Recommendations
VII. Exhibits[30]

Following this format, the auditor conveys early in the report those matters of greatest significance. This provides the manager with an overview of the situation and gives him the option of proceeding to obtain the details. Additionally, the manager can read the opinions of his operating personnel regarding the situation and evaluate their position in comparison to that of the auditor. The latter aspect of reporting is of significance because it presents a balanced viewpoint of the situation.

Discussion With Local Management. The consensus of opinion that the discussion of audit results with those audited is necessary and important is indicated by the Lamperti-Thurston survey. In presenting a narrative of the results, they state:

> Most companies agreed that, to be most effective, an audit report should represent not only the findings and recommendations of the auditor but also the results of discussions with the audited organization. The latter's comments on the findings and their statements as to what action should be contemplated are considered an essential part of each report. This practice, it is maintained, makes the report more effective as a management tool by reducing the time that executives would otherwise need to obtain all points of view.[31]

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[30]Leonard, op. cit., p. 173.

[31]Lamperti, op. cit., pp. 397-398.

The advantages of such a review with local management are as follows:

1. It is good human relations and shows that the internal auditor is working with local personnel, not against them.
2. Full opportunity is given for discussion of the point involved.
3. Where the local man agrees with the finding and recommended action, the matter can be closed, except for reference in the report.
4. Some matters are of such a nature that prompt or immediate action is required.[32]

The creation of good working relations with local management is very important, and this is one method of improving them. As stated previously, the auditor must act with tact and discretion in dealing with the operating personnel. The atmosphere of harmonious working relationships assists the implementation of corrective action more than an environment of hostility between auditors and local personnel. After the closing conference with the unit audited, the audit report must be prepared for submission to higher echelons.

Distribution of the Report. The highest level of management to which an audit report is forwarded varies with company policy. Two reasons for the diversity among companies are their particular organizational structure and the general enthusiasm of management toward the auditing function. The Lamperti-Thurston survey reveals that:

> There was a wide variation between companies in respect to the top official receiving audit reports as a matter of regular routine. . . Specifically, no company

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[32]Thurston, op. cit., p. 76.

> reported forwarding such reports to the board of directors and only a small number sent them to the president. Most companies do send the reports to the vice-president or administrative executive in charge of an operation as well as to the chief administrative officer in charge of the location or function audited.[33]

The literature reviewed reveals general agreement on the distribution of reports to those units audited and other management officials who have a responsibility for items contained in the report. However, the means of submitting the information vary from sending the entire report to sending a monthly or quarterly bulletin of all major findings to the executives concerned.

The responsibility for determining the distribution of reports usually rests with the official to whom the chief auditor reports. This official reads and digests the whole report and makes the decision on those items which should be discussed with other executives.

The final distribution of the report does not bring the auditor's job to an end. His service to management is completed only upon implementation of corrective action. This necessitates some form of follow-up or control system which usually lies within the office of the chief auditor in decentralized organizations. The control system normally consists of a report from the audited activity to the chief auditor who has set up target dates for these corrective actions. Further control is provided by the auditor's next review to ensure actual implementation, not just the reporting of such.

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[33]Lamperti, op. cit., p. 398.

V. SUMMARY

This chapter discloses how the internal auditing function now utilized in industry evolved from the auditing of public accountants. The addition of internal auditors took place due to the constant expansion and diversification of industrial concerns which caused management to become separated from normal day-to-day operations. Internal and management control systems helped provide assurance for top management that the organization was moving toward its objectives. However, it was necessary to evaluate the compliance with and effectiveness of the control systems. This job is part of the internal auditor's function today.

Of significant importance is the trend of internal auditing to become involved in areas far removed from the financial aspect of business. For years, the auditor was mainly interested in financial and accounting operations. However, in the 1950's auditors began to review and appraise conditions in such areas as procurement, inventory management, and advertising. This changing trend is not an indication of diminishing importance of financial audits, but instead is an indication of the additional responsibilities of internal auditors. The whole spectrum of business activity is opening up to the auditor's review in hopes that his effort will provide management with information that will enable it to make sound decisions.

The discussion of organization and personnel of a firm's audit unit reveals that many policies in these areas vary among companies. Decentralization of the audit organization is dependent upon the size,

diversity, and geographical location of the total organization. The executive to whom the chief auditor reports also varies; but it is evident that this executive must be a member of the management team. The employment of the highest caliber of personnel and a program for continuing personal development are required to provide management with optimum service. A controversy exists among various writers, both theorists and auditors, regarding the requirement for audit organizations to have personnel educated and experienced in such diverse fields as industrial management, industrial relations, and inventory control. Some feel that this would change the organization into an internal management consulting unit; others feel that to provide management with the service it desires in light of the current expansion into these other areas it has become imperative that knowledgeable auditors be available to review and appraise these areas. The latter argument appears more sensible since it is the service that is important, not the title given to the organization.

Finally, the tremendous importance of a well organized and well written audit report is discussed. The report represents the auditor's means of communication with top management and, as such, is a selling device for the auditor. Therefore, he must take great patience to ensure its contents are well thought out, organized, important enough for executives to read, and not likely to be misinterpreted. Before writing the report, a closing conference with local management is necessary to obtain its formal agreement or disagreement on items in the report. When these opinions are

included in the report, management is saved the trouble of obtaining them and gets all views at one time. The discussions provide auditors with an opportunity to create rapport with local management, making future audits much easier.

As a concluding remark, the literature reviewed indicates that an internal audit organization serves an important function in industry. Its value to management is revealed in its current willingness to have auditors review and appraise aspects of the business outside the financial area. With this chapter as a background, the discussion now turns to internal auditing in the Navy--its development and current practices.

CHAPTER III

HISTORICAL DEVELOPMENT OF INTERNAL AUDITING

Before examining current operations of the internal audit organization, a review of the evolution of internal auditing in the Federal government, particularly the Navy, will be helpful in understanding the philosophy of the organization. Additionally, this brief history may clarify some of the current policies and procedures described in Chapter IV.

The main points of the chapter will be, first, the development of internal auditing in the Federal Government from the time of the Continental Congress through the passage of the Budget and Accounting Act of 1921; second, the passage of Public Law 216 and the Budget and Accounting Act of 1950 and their implications, and the establishment of Navy Internal Audit; and finally, the original objectives of the Internal Audit organization of the Navy.

I. FEDERAL INTERNAL AUDITING, 1700-1948

Revolutionary Period. Internal auditing in the United States began during the years of the Revolutionary War when the Continental Congress appointed a committee to examine and report on claims submitted in order to ensure their legality prior to payment. After the war and the ratification of the Constitution:

> . . . the First Congress established a "Treasury Department" and provided for the appointment by the President, subject to Senate confirmation, of five Treasury officers: a Secretary, acting as a general supervisor, an Auditor who was to receive and certify vouchers for payment, a Comptroller to review the Auditor's certifications, a Register to keep books, and a Treasurer to pay certified bills.[1]

This is the first mention of auditing in the Federal Government with a brief description of the auditor's function. The verification of vouchers for payment has been discussed in the previous chapter, and it was shown that this task is a part of the internal check and control system of any organization. Although the term "auditor" was acceptable in identifying the person performing this task in the eighteenth and nineteenth centuries, it is no longer applicable.

By the action of the First Congress, responsibility for controlling government expenditures was given to the Executive branch. This left Congress with the Appropriations Act as its only means of control over federal spending. Presumably, the Executive branch of the government functions to carry out the "will of the people" as expressed by Congress in a democratic society. Since Congress is, in essence, the highest level of management and the Executive branch its administrator a basic principle of management control had been violated, i.e., management had no control over the utilization of resources.

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[1]Eric L. Kohler and Howard W. Wright, Accounting in the Federal Government, (Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1956), pp. 69-70.

The lack of Congressional control over utilization of the federal resources remained as such until the passage of the Budget and Accounting Act of 1921.

The Twentieth Century. During the early part of the 1900's, industry and government gained more knowledge about management principles and techniques. The idea of an administrator's accountability to those who establish policy became prevalent and desirable in the federal government. The passage of the Budget and Accounting Act of 1921 transferred the Comptroller and six auditors of the Treasury Department to a new agency, named the General Accounting Office. This agency was responsible directly, and only, to Congress. Two of the most important functions of GAO were the development of accounting and auditing principles for application in government agencies and the periodic post-auditing of all governmental agencies with respect to their financial operations. Thus, the groundwork was laid for auditing to be used as a management tool in the Federal Government.

Since Congress is the highest level of management in the Federal Government, a comparison with management in private industry can be made. Congress can be likened to the Board of Directors of any large corporation and the GAO function of control, through auditing, is analogous to the public accountant's service to the directors of a corporation. The Executive departments (corporate management) were also in need of a more continuing type of auditing function than could be provided by the

external auditors, GAO. The passage of Public Law 216 in 1949 provided the means to fulfill this requirement.

II. MILITARY COMPTROLLERSHIP AND AUDITING

The Need for Improved Financial Management. When the United States entered World War II, more of our resources were diverted to the war effort than heretofore imaginable. During this period, the means (utilization of resources) to the end (winning the war) were of little interest as long as the latter was positive. The ending of the war, however, did not bring the expected alleviation of world tension. Consequently, the United States military posture could not be allowed to deteriorate as it did after World War I, and the military departments were faced with maintaining a nucleus of military power on peacetime budgets. Since the billions of dollars spent for wartime defense could not be justified, an increasingly critical eye was focused on military expenditures. The first Hoover Commission, reporting to Congress in 1949, stated:

> . . . the maintenance of a huge military force and of enormous military budgets in peacetime poses a severe problem. It introduces a new element into our social and political life; this spending, both as a drain on the taxpayers and as purchasing power, can vitally affect our economy. The degree of our success in achieving efficiency of military operations and planning, economy in execution and proper relationship of this new force to our political and economic fabric can make the difference between democracy and totalitarianism, both for our Nation, and for the whole world.[2]

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[2]Bureau of Naval Personnel, Financial Management in the Navy, (NAVPERS 10792-A: Washington, D.C., 1962), p. 9.

Congressional Action. Congress and the Executive branch of the government were aware of the effects of military spending and foresaw a need for improved financial management in the military establishment. In the same year as the Hoover Commission report, Congress passed and President Truman signed Public Law 216, TITLE IV, which amended the National Security Act of 1949. TITLE IV established Comptrollers in the Department of Defense and the three military services responsible to their respective secretaries for the financial management of the Department of Defense. One of the responsibilities of the Comptrollers is internal audit, as specified in Section 401 (b)(2)(A)(iv) and Section 420 (b), which states, in part:

> Subject to the authority, direction, and control of the Secretary of Defense, the Comptroller shall . . . establish, and supervise the execution of . . . principles, policies, and procedures to be followed in connection with organization and administrative matters relating to . . . internal audit
> . . . . . .
> There is hereby established in each of the three military departments a Comptroller of the Army, a Comptroller of the Navy, or a Comptroller of the Air Force, as appropriate in the department concerned. There shall, in each military department, also be a Deputy Comptroller. Subject to the authority of the respective departmental Secretaries, the Comptrollers of the military departments shall be responsible for all budgeting, accounting, progress and statistical reporting, and internal audit in their respective departments and for the administrative organization structure and managerial procedures relating thereto.[3]

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[3]United States Statutes at Large, Laws and Concurrent Resolutions Enacted During the First Session of the Eighty-First Congress of U.S.A., Volume 63, Part 1, (Washington, D.C.: U. S. Government Printing Office, 1950), p. 586.

The desire for improved financial management was further emphasized by the passage of the Budget and Accounting Act of 1950. This act enabled the Executive Branch to develop more modern and simplified accounting and auditing methods in order that better management would ensue. Again, internal auditing is referred to as a means to improved financial management, as Section 113 (a)(3) states:

> The head of each executive agency shall establish and maintain systems of accounting and internal control designed to provide . . . effective control over and accountability for all funds, property, and other assets, for which the agency is responsible, including appropriate internal auditing.[4]

Establishment of Navy Internal Audit. Within the purview of the foregoing Congressional action, the Secretary of the Navy approved a Charter of the Comptroller of the Navy on 1 June 1950. The responsibility of internal auditing was given to the Assistant Comptroller-Accounting, Audit, and Finance. Another type of audit, contract audit (evaluation of defense contractors' submissions of cost for reimbursement) was at this time the responsibility of the Bureau of Supplies and Accounts.[5] In 1953, the responsibility for contract audit was reassigned to the Comptroller's Office. After reorganization, the Assistant Comptroller-Audit was given responsibility for contract and internal audits. The title of Assistant Comptroller was changed in 1962 to Auditor General of the Navy. For

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[4]United States Statutes at Large, Laws and Concurrent Resolutions Enacted During the Second Session of the Eighty-First Congress of U.S.A., Volume 64, Part 1, (Washington, D.C.: U. S. Government Printing Office, 1952), p. 836.

[5]Bureau of Naval Personnel, op. cit., p. 204.

consistency, the title of Auditor General will be used henceforth when referring to the top official of the Navy's Internal Audit organization, regardless of the period of time under discussion.

The responsibilities of the Comptroller of the Navy and the Auditor General, as related to internal auditing, were stated in the Charter of the Comptroller of the Navy, approved on 1 June 1950. Under the Charter, the Auditor General was required to:

> Develop audit principles, policies, and procedures and exercise technical supervision of audit operations in and throughout the Department of the Navy.
>
> Perform audits and examinations, as required, of systems, procedures, records, and documents pertaining to the obligation of and expenditure of appropriated funds, property accounting, sales and reimbursements and of non-appropriated funds.
>
> Coordinate with the Naval Inspector General, to the fullest extent feasible, audits and examinations of field activities.
>
> Coordinate Navy audit programs, as required, with the Comptroller of the Department of Defense, the General Accounting Office and other government agencies.[6]

Original Objectives. Within the framework of the laws and regulations passed by Congress and the general policies of the Secretary of the Navy, the Auditor General established specific objectives of the organization to fulfill his responsibilities. These initial objectives were to:

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[6]Office of the Comptroller of the Navy, Internal Auditing--Principles, Policies, Minimum Standards and Objectives, (Washington, D.C., 1951), pp. 1-2.

a. Determine that policies and procedures prescribed in the entire field of comptrollership are being complied with and that the interests of the Government are adequately protected.

b. Prescribe internal audit principles, policies, procedures and programs.

c. Perform internal audits at the departmental and field levels; review financial reports prepared by field installations; and prepare reports on the propriety, fidelity, legality, accuracy, adequacy, and effectiveness of budgeting, accounting, and reporting systems, procedures, records and documents, for appropriated, revolving, and non-appropriated funds, property, sales, expenditures, refunds, and reimbursements.

d. Determine that the system of automatic checks and balances established and maintained at various levels throughout the Navy is sufficiently adequate so that no individual is in complete control of all phases of a transaction, but must coordinate his work with others, follow legal requirements and prescribed policies, and be subject to examination.

e. Determine that reliable and timely accounting and statistical reports are distributed to each echelon requiring their use.

f. Detect failure in specific cases to follow prescribed accounting policies, procedures, and accepted practices in management areas.

g. Make recommendations and reports to the Comptroller of the Navy for financial, cost and property accounting improvements.[7]

A comparison of these objectives and Brink's definition of internal auditing in the preceding chapter reveals the similarity between the two. The original objectives of Navy Audit were concerned only with accounting and financial matters. There is no indication in the above statement that internal auditors would review or appraise nonfinancial operations of the

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[7] Ibid., pp. 6-7.

Navy. The purpose of the next two chapters is to determine if these objectives have changed over the years as they did in industrial internal audit.

III. SUMMARY

Although internal auditing did not gain recognition as a profession for many years, its beginnings are traceable as far back as the Revolutionary War. The auditing during this time consisted of an examination to determine the legality of payment and the compliance of operations with rules and regulations. Prior to the 1900's, auditing offices were responsible to the Executive Branch of the government, but there were many who felt that this responsibility should rest with Congress. The Budgeting and Accounting Act of 1921 established an independent agency called the General Accounting Office, responsible only to Congress, for conducting audits of all Executive agencies and their suborganizations.

After World War II, the necessity of maintaining our military posture with a limited amount of resources made it imperative that the most modern methods and techniques of management be utilized. One step toward this goal was the establishment of Comptroller Offices in the Department of Defense and the three military services as directed by Public Law 216, TITLE IV, in 1949. As part of the improved financial management plan, the service comptrollers were given the responsibility for internal auditing. The Charter of the Comptroller of the Navy was approved by the Secretary

of the Navy in 1950, and the responsibility of internal auditing was vested in the Assistant Comptroller-Audit whose title was changed to Auditor General of the Navy in 1962.

Finally, the original objectives of Navy Audit are stated, and a comparison with the definition of internal auditing given in 1941 shows their similarity. It is evident that the original purpose of internal auditing in the Navy was financially oriented. For the most part, auditors were interested in compliance with policies and procedures, and the fidelity, accuracy, and adequacy of accounting and financial systems.

CHAPTER IV

NAVY INTERNAL AUDIT POLICIES AND PRACTICES

The discussion to this point has concerned itself with the development and present status of internal audit in the industrial community and its evolution in the Navy. The objectives of Navy Audit given in the last chapter are concerned only with accounting policies, systems, procedures, and performance.

The first point of discussion in this chapter is a review of current objectives and a determination of whether they have changed over time, as industry's have, or have remained stagnant. Second is the organizational structure within which Navy Audit operates and its own organization. Third, and related somewhat to the objectives' section, is the type of audits performed by the audit offices. As in the first chapter, individual techniques and steps followed in an audit are not discussed since there are so many types of audit and functional areas covered that it is believed beyond the scope of this paper.

The fourth section probes the personnel contribution to the audit effort. A review of personnel policies in recruitment, training, performance evaluation and career development is conducted to determine whether the personnel program of the audit organization is keeping pace with changing times. Finally, a review of the audit reporting system is made to determine its effectiveness as a means of management information.

1. OBJECTIVES OF NAVY AUDIT

From its inception in 1951 until 1955, Navy Audit was primarily concerned with the accounting and fund systems in operation throughout the Navy. In 1956, however, the audit organization restated its objectives which, although similar to the 1951 statement, show one significant departure. The objectives are stated as follows:

> To provide a protective and constructive service to all levels of management. . .
> as to the adequacy and effectiveness of budgeting, accounting, financial and related policies and procedures.
> as to the extent of compliance with applicable statues, regulations, policies, and prescribed procedures.
> as to the reliability, accuracy, and completeness of financial and other records and reports.
> as to whether funds and other resources are properly protected and effectively used.[1]

The significant difference between the two statements of objectives is in the last two words of the later statement--effectively used. The addition of these two words means that not only could the auditor review all the normal financial aspects of a Navy office, bureau, or activity, but he now has the responsibility to determine whether "funds and other resources are effectively used." The appraisal of management's effective utilization of resources, i.e., money, men, and material, covers a much broader area than the auditing of accounting systems. The question can be

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[1]Office of the Comptroller, Department of the Navy, Internal Audit of the Naval Establishment, (NAVEXOS P-1501, 1956), pp. 10-11.

raised regarding the authority of Navy Audit to include such a statement in its objectives. Previous authoritative statements concerning the auditing function, i.e., Public Law 216 and the Comptroller's Charter, do not give any indication that auditors could venture into the areas of management operations. There are two possible answers to such a question: first, top Navy management was aware of the benefits to be gained by using such a management tool, and second, the Department of Defense encouraged its use.

Department of Defense Audit Policy. In 1957, the Secretary of Defense, C. E. Wilson, promulgated the Department's policy on the auditing function. In regard to internal audit, the directive states:

> The purpose of internal auditing is to provide those responsible for management at all levels with an independent, objective and constructive evaluation of the effectiveness and efficiency with which financial responsibilities are being carried out. All organizational components and levels of operations will be subject to independent and comprehensive audit review and appraisal. Internal audit activities will include examining and appraising policies, systems, procedures, records and reports relating to budgeting, accounting, financial or business transactions of all kinds, and matters of a related nature.[2]

In reading this defintion, there appears to be little difference between it and the "original objectives" of Navy Audit set forth in 1951. However, a few key phrases, such as "effectiveness and efficiency with which financial responsibilities are being carried out", "business transactions

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[2]Secretary of Defense, Department of Defense Audit Policies, (SECDEF Instruction 7600.2, 7 August 1957), p. 2.

of all kinds", and "matters of a related nature", require further examination. The use of such phrases leaves a tone of vagueness as to just what an auditor can review and appraise. It can be reasonably argued that "financial responsibilities" refers to an operating manager's utilization of resources and not to the chief accountant's method of keeping the books. Accounting and financial personnel have no financial responsibility per se; they merely collect, record, interpret, and present data relating to the use of resources. If this interpretation is accepted, then DOD policy indicates that auditors do have a responsibility to review and appraise the effectiveness with which a manager uses his resources. The other phrases, "business transactions and matters of a related nature," can also be interpreted in various ways. The American College Dictionary defines "business" as "the purchase and sale of goods in an attempt to make a profit"[3] and "transact" as "carry/ing/ through (affairs, business, etc.) to a conclusion or settlement."[4] Combining these two terms, a "business transaction" in our private economy can be defined as the accomplishment of the acquisition and transformation of resources into a product which can be sold for a profit. The Department of Defense goes through the same process except for selling to obtain a profit. When DOD gives auditors the authority to review and appraise

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[3]C. L. Barnhart, The American College Dictionary, (New York: Random House, 1963), p. 162.

[4]Ibid., p. 1285.

the policies, systems, and procedures of business transactions, it can be argued that all aspects of the acquisition and transformation of resources into our "end product"--defense of the Nation--are within the auditors' jurisdiction for review.

Although some business managers within the Navy may not accept these arguments, DOD emphasized, in the early sixties, the need for auditors to review areas of management operations other than accounting and fiscal. The Review of Management of the Department of the Navy (Dillon Report) also stresses this in its report which states:

> The interest of OSD in assuring implementation of its audit directives is indicated in a memorandum addressed to the three services on 16 May 1960, which states that sufficient audit coverage, both from the standpoint of depth and scope, had not been made in significant management areas (outside of the accounting and bookkeeping area), such as procurement, determination of requirements, inventory management, and utilization of resources. This amplification of the basic OSD audit directives, particularly as it refers to resource utilization, removed any doubt concerning the responsibility of the auditor to deal routinely with matters of an operating nature (except tactical) that have a financial relationship. Accordingly, the audit programs in these and similar areas where strengthened and greater audit emphasis was placed on <u>how the Navy's dollars are spent rather than on how they are recorded</u>. /italics in the original/[5]

There is absolutely no vagueness in this statement as to the responsibility of the auditor.

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[5]S. H. Ivison, Captain, USN, <u>Review of Management of the Department of the Navy: Financial Management Study</u>, Volume II, Study 7, (NAVEXOS P24268-7, 1962), p. 50.

Although DOD stated that the auditing being done in management areas removed from accounting was not sufficient, the Navy had been conducting audits in procurement and supply management for several years. Also, it will be remembered that the Navy made reference to auditing the utilization of resources in its 1956 objectives. Though the caliber of the audits in these areas obviously did not meet the expectations of DOD, the Navy was at least aware of their importance and was taking steps to improve their service to management. Based on the foregoing, it can be stated with some confidence that the Navy was keeping abreast of the concept of internal auditing as utilized by industry and envisioned by DOD during the decade of the fifties.

Current Objectives. In the 1960's, Navy management found itself becoming involved with more sophisticated means of accomplishing its goals. Probably the most influential instrument in this trend is the use of faster and more flexible computers. These machines enable management to computerize inventory control systems, integrated management information systems in shipyards, particular procurement actions at inventory control points, and personnel information. As Naval management became more sophisticated, the need for review and appraisal of policies, procedures, systems, performance, and controls in all management areas became more important. Today, the most important objective of Navy Audit is to assist the manager, regardless of position, in accomplishing his objectives effectively and efficiently. As Rear Admiral Stanley, former Auditor General, states:

> Navy auditing successively expanded from a verification of fidelity and compliance to the evaluation of internal financial controls, the review of procedures, study of the use of management controls to enhance efficiency, and evaluation of all aspects of the business managers' accomplishments. The objective of internal auditing, past and present, is to increase management effectiveness.[6]

Admiral Stanley in another article, refers to the statement of objectives in the Navy Internal Auditors Handbook, which are as follows:

> The chief objective of internal auditing is to assist management at all levels in the effective discharge of its responsibilities, by furnishing objective analyses, appraisals, recommendations, and pertinent comments concerning the activities reviewed. The internal auditor, therefore, should be concerned with any phase of the business activity wherein he can be of service to management. Internal audit discloses the existence and causes of errors, and thus provides protective service to management. When policies prescribed by management are found to be inadequate or ineffective, or prescribed procedures are found to be awkward or uneconomical, internal audit recommends appropriate changes. In addition, internal audit reviews all aspects of operations (except tactical) which involve the use of public funds or resources, and makes recommendations to achieve economies or to improve efficiency and effectiveness.[7]

Again, reference is made to auditing all aspects of the business activity. With all that has been stated, it is concluded that the objectives

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[6]E. D. Stanley Jr., Rear Admiral, SC, USN, "Internal Auditing in the Navy," The Federal Accountant, XIV (Winter, 1964), p. 43.

[7]E. D. Stanley Jr., Rear Admiral, SC, USN, "Internal Audit in the Navy," The Armed Forces Comptroller, IX (September, 1964), p. 10.

of Navy Audit extend into areas other than the financial aspects of the Shore Establishment's operations. In view of this, Navy Audit is maintaining the same level of service to management as is found in the industrial community today. This conclusion gains even more credence when the types of audits conducted by Navy Audit are discussed in Section III. However, the organizational structure within which Navy Audit operates and its own organization warrant discussion at this time.

II. ORGANIZATION

Within the Navy Department. As in most industrial firms, the Auditor General of the Navy reports to the Comptroller of the Navy who is ultimately responsible for auditing activities. In the Navy, the Assistant Secretary of the Navy for Financial Management is also designated as the Comptroller. Consequently, the Auditor General reports to a top level of executive management. Through this chain of command the Auditor General presumably maintains complete independence from operating management. An argument can be raised, however, regarding the review and appraisal of accounting systems, budget procedures, and financial reporting systems in that these functions are the responsibility of the Comptroller; consequently, the independence of the Auditor General may be limited. Since any constructive criticisms of the effectiveness of accounting systems emanating from the Auditor General would be directed to his immediate superior, the proponents of this argument would suggest that the Auditor

General, to maintain his independent status so that his effectiveness is not curtailed, should report directly to the Secretary or the Under Secretary of the Navy. An academic rebuttal to this argument is that the optimum allocation of their time does not permit the enlargement of their span of control; therefore, the Auditor General should report to the next highest echelon of executives available, which is the Assistant Secretaries.

The factual rebuttal is that it was Congress' intent to have the Department of Defense Comptroller, who is also an Assistant Secretary, responsible for internal auditing.[8] The Secretary of Defense issued similar directives to the services which state:

> All audit responsibilities. . . continental United States and overseas, shall be carried out by a single audit organization in each department in order to assure independence and to avoid duplication. The head of the central audit organization in each military department will be responsible to the Comptroller of the Department. However, in those cases where the Assistant Secretary for Financial Management is not designated as Comptroller, departmental arrangements shall provide for direct channels of communication between the head of the audit organization and the Assistant Secretary for Financial Management.[9]

Since the Auditor General reports to the Assistant Secretary for Financial Management, who is acting as a direct representative of the

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[8]United States Statutes at Large, Laws and Concurrent Resolutions Enacted During the First Session of the Eighty-First Congress of U.S.A., Volume 63, Part I, (Washington, D.C.: U. S. Government Printing Office, 1950), p. 586.

[9]Secretary of Defense, Department of Defense Audit Activities, (SECDEF Instruction 7600.3, 13 January 1958), p. 2.

Secretary, rather than the Navy Comptroller, it is maintained that he retains his independent status and reports to a very high level of management.

Internal Organization. Since the purpose of Navy Audit is to provide a service to all levels of management within the Navy, the fulfillment of this objective necessitates an organization that reaches all corners of the globe. With AUDGENAV headquarters located in Washington, D. C., the organization is geographically decentralized to provide this service. There are nine field offices called Navy Area Audit Offices (NAAO) located in Boston, New York, Philadelphia, Washington, Norfolk, Chicago, San Francisco, Los Angeles, and San Diego. The selection of these locations was based primarily on the heavy concentration of Naval activities in these areas. In order to provide audit service to the overseas activities, Navy Branch Audit Offices (NBAO) operate in London, Honolulu, and Yokosuka. There is also a NBAO located in Seattle which is responsible to the San Francisco NAAO. In addition, the field offices, NAAO and NBAO, have Navy Audit Offices (NAO) established throughout their geographical jurisdiction.[10] The NAO's are placed in locations where audits are continuous due either to the number of activities in the particular locale, or the immense size of the individual activity. The staffing of the field offices consists of 306 civilian and 48 military auditors/supervisors

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[10]Stanley, op. cit., p. 10.

and a small Management Service staff at each NAAO which provides a support function.

The cost of operating this dispersed organization in the Fiscal Year of 1964 was $4.2 million; the following table shows a breakdown of the total costs:[11]

TABLE I

OPERATING COSTS OF THE INTERNAL AUDIT FIELD OFFICES -FY 1964

	AMOUNT	PERCENT
Civilian Personnel Salaries	$2,924,000	69
Civilian Personnel Benefits	220,000	5
Civilian Travel	306,000	7
Civilian Support	438,000	10
Military Costs	360,000	9
	$4,248,000	100

Although $4.2 million appears to be a large amount of money to expend for audit service, a comparison with the total Navy net expenditures ($14.5 billion)[12] in 1964 shows that it is extremely small (.03%) and that the service provided should justify this portion of the Navy's budget.

It should be noted that Table I does not include the costs of the headquarters office in AUDGENAV. Although this information is not available, a generalization of its size can be made. Prior to the centralization of the contract audit function under DOD, the headquarters staff consisted of

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[11]P. B. Nicks, Captain, SC, USN, Enclosure to letter of 4 May 1965.

[12]Office of the Comptroller, Department of the Navy Budget Digest, Fiscal Year 1965, (NAVEXOS P-1355, 30 October 1964), p. 40.

54 people, including both military and civilian, while the total audit organization employed 1400 personnel.[13] This represents approximately a 1 to 26 ratio of staff to total employees, and if this ratio is applied to the 1964 field office employees (354), approximately 14 people would constitute the staff at AUDGENAV.

The organization of the Auditor General's headquarters staff is discussed under the hypothesis that the movement of the contract audit function to DOD has not changed the organizational structure with respect to internal audit. The Auditor General has a Director in charge of the Internal Audit Division who is responsible for the overall planning, directing, coordinating, and controlling of the internal audit functions throughout the Navy. There are also three Assistant Directors who aid in administering the overall program and have responsibilities in specific areas of their own. They are the Assistant Director for Planning, who is specifically interested in manpower requirements, work load distribution, audit scheduling, and long range goals; the Assistant Director for Performance whose responsibilities are the control and improvement of the audit effort, and the policies and procedures to be followed by field offices; and the Assistant Director of Reports, who is responsible for the audit reporting system, the review of audit findings and recommendations, and the evaluation of management objectives.[14]

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[13]Stanley, loc. cit.

[14]Bureau of Naval Personnel, Financial Management in the Navy, (NAVPERS 10792-A, 1962), p. 205.

Within the last several years, the Auditor General has established three new divisions at the headquarters office to meet the challenges of increased management sophistication. One of these, the Professional Staffing Division, is discussed in another section. Another is the Audit Management Division. Its purpose is to present to top audit management a measurement of resources (audit input) in relation to output (audit product).[15] From this information, audit management determines the allocation of resources that results in the most effective audit program and proves most beneficial to the Navy. The other division, Audit Analysis, is described by Admiral Stanley as follows:

> Audit analysis is the moving forward with the rapidly developing state of the arts--and sciences--of audit and management. In order to keep abreast of changing times, AUDGENAV maintains a staff of management experts who will influence Navy audit with the latest developments in the fields of operations research, management controls, methods engineering, automated data processing, and written communications.[16]

Both of these divisions provide a staff function to the field offices. The Management Audit Division's information is sent to the NAAO's on a quarterly basis to aid in better utilization of their resources. The information gathered by the Audit Analysis group on new techniques and developments in the management science field is promulgated to field offices.

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[15]E. D. Stanley Jr., Rear Admiral, SC, USN, "Internal Auditing in the Navy," The Federal Accountant, XIV (Winter, 1964), p. 56.

[16]E. D. Stanley Jr., Rear Admiral, SC, USN, "Internal Audit in the Navy," The Armed Forces Comptroller, IX (September, 1964), p. 13.

The organization of AUDGENAV corresponds very much to private industry's organizational structure, both within and in relation to the rest of the organization. Navy Audit's vastly decentralized structure permits servicing the needs of all levels of management in the Navy. As noted, this service is provided at a relatively low cost to the Navy as a whole. The recognition of the importance of keeping abreast of changing methods and techniques and constantly reviewing the input-output relationship of its own efforts is indicative of forward management thinking and planning in the audit organization.

III. TYPES OF AUDITS

Before discussing the various types of audits conducted by Navy Audit, a look at the distribution of manhours in the Fiscal Year 1964, as collected by AUDGENAV, will serve to add perspective to this discussion. Table II shows this distribution:[17]

TABLE II

MANHOUR DISTRIBUTION FOR FIELD OFFICES-FY 1964

	MANHOURS	PERCENT
Fidelity	8,000	1
Activity	235,200	42
Cost Reduction	94,800	17
Servicewide	90,300	16
Regional	92,400	17
Special	38,500	7
	559,200	100

[17]Nicks, loc. cit.

Fidelity Audits. The verification of public funds in the possession of authorized personnel and the applicable records and controls that serve to safeguard these funds is the main purpose of fidelity auditing. Although these audits were of prime importance in the early years of the audit program, today they constitute only one percent of the audit effort. The main reason for this is the increasing emphasis on management type audits. This decline can be real, i.e., less manhours are actually expended on these audits; or as the total audit effort has increased over the years and shifted to other types of audits, the proportion of fidelity audit effort to the total has gradually decreased. Although figures are not available for this type of analysis, it is suggested that both are inherent in the decline of fidelity audits.

Activity Audits. The audits conducted at individual activities represent the major portion of the audit effort in the Navy. Through these audits local management receives a constructive review and analysis of its operations in relation to its effectiveness and efficiency. The audit coverage takes in all functional areas within the scope of operation. These functional areas are, but not limited to, the following:

Budgeting for appropriated funds
Procurement
Appropriation and fund accounting
Plant property accounting
Stores accounting
Cost accounting
Timekeeping and civilian payrolls
Disbursing
Navy Industrial Fund Accounting
Navy rental housing facilities

Supply management
Inventory management
Government property in the possession of contractors
Commissary stores
Commissary (General Mess)
Navy Regional Accounts Offices[18]

As an example of the broadening scope of the audit function and its involvement in areas removed from accountancy and related topics, some of the evaluations in the inventory management area may be to:

1. Determine whether pertinent regulations and prescribed policies and procedures are being complied with and whether adequate implementing procedures and instructions have been published within the pertinent supply system, as appropriate.

2. Evaluate the effectiveness of the internal controls relating to the entire inventory management operation under the control of each cognizant bureau and supply demand control point.

3. Test and appraise the basis for the determination of quantitative requirements, the criteria used, and the reporting system prescribed.

4. Evaluate policy, and test and appraise procedures relating to redistribution, procurement, standard pricing, repairable material, excess stocks, and critical items.

5. Test and appraise the records and reports, and determine whether they are accurate, adequate, and meet the requirements of applicable regulations and instructions.

6. Determine whether mobilization reserves and materials in long supply are subject to close and continuing scrutiny and are handled in accordance with all pertinent directives and good business practice.[19]

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[18]Bureau of Naval Personnel, op. cit., p. 207.

[19]Ibid., p. 208.

Evaluations such as these indicate that Navy Audit is not operating under the earlier concepts of auditing and is attempting to provide pertinent information to management.

Obviously the coverage of the functional areas at large activities involves a more extensive audit period than at smaller ones. Therefore, activity audits are separated into continuous and periodic audits. The continuous audit is used at large activities, e.g., Naval shipyards, supply depots, and inventory control points; and under it, functional areas, applicable to the activity under audit, are reviewed separately with full coverage being completed on a three year cycle. If particular functions are more important than others and are not operating effectively, reviews may be made annually, whereas less important areas may be reviewed only once in three years. In order to accomplish the continuous audit, a staff of auditors resides at the activity permanently. They are responsible to the NAAO to which they are assigned and have no responsibility to the local command except in a service capacity.

The periodic audit is conducted at smaller activities and consists of a team of auditors visiting the activity approximately once every three years. During this visit all functional areas applicable to the activity are reviewed to determine the effectiveness and efficiency of operations.

Cost Reduction Program Audits. One of the programs instituted by Secretary of Defense McNamara to increase the efficiency of operations in the military departments and thereby reduce costs is the Cost Reduction

Program. Under this program, each activity in the Navy attempts to find ways in which it can perform its mission at a lower cost.

When any change in methods of operating is made, cost savings are determined and reported to the management bureau or office. This program has resulted in actual savings to the military, cost avoidance situations, and cost consciousness in military and civilian personnel. In order to be assured that the reports of savings are legitimate, the Secretary of Defense requires the reported savings to be reviewed by the service audit agencies who verify their authenticity. The manpower utilized by Navy Audit in this program represents seventeen percent of its total effort. Since this type of work is similar to fidelity auditing, the worth or effectiveness of the audit resource utilization (manpower) is questionable. If the percentage of dollar savings erroneously reported is small, it appears that a shift of audit resource to another area is desirable. If it can be shown that the effectiveness of this particular utilization of resources is not optimal in relation to the total audit effort, it is believed that the Secretary of Defense would eliminate the requirement for this audit function.

Servicewide Audits. This type of audit is a recent innovation in the audit effort, the first being conducted in 1961. The purpose of a servicewide audit is to review and appraise a functional area or program throughout the entire Navy Department. The servicewide audit is analogous to the "total system cost analysis" studies conducted on procurement proposals within

the Department of Defense. The obvious advantage of this audit is the prevention of suboptimization, i.e., examining parts of a system independent of their effects on each other or the total system. As Admiral Stanley states, "This Navywide approach permits total perspective, with findings at each location considered in the light of findings at other locations."[20] By the end of FY 1964, two such audits had been completed by the Navy. The first was an audit of "Selected Phases of the Repairable Aeronautical Material Program of the Naval Aviation Supply System"; the other, "Supply System Responsiveness to Fleet Requirements for Ships Assemblies and Repair Parts." Conservative projections of annual cost avoidance resulting from recommendations in these audits are $60 million for the Aeronautical Material Program and $50 million for the Ships Assemblies and Parts Supply System.[21] When consideration is given to the total operating costs of Navy Audit ($4.2 million) and a cost avoidance of $110 million resulting from two servicewide audits, the service to management provided by the audit organization can hardly be criticized.

Regional Audits. These audits operate under the same concept as the servicewide audits, but on a smaller scale. A particular function or program in a limited geographical area is reviewed with the purpose of

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[20]E. D. Stanley Jr., Rear Admiral, SC, USN, "Internal Auditing in The Navy," The Federal Accountant, XIV (Winter, 1964), p. 56.

[21]Ibid., p. 48.

increasing effectiveness and efficiency at all levels within the area. Examples of regional audits are as follows:

> . . . the audit of the effectiveness of procurement, stocking and inventory control of Navy owned stocks of lumber and related products in the San Diego area; utilization, maintenance and management of materials handling equipment in the Fifth and Sixth Naval Districts; and the propriety for travel and per diem payments and the adequacy of internal controls exercised over such payments in the Norfolk area.[22]

Special Audits. Various types of audits fall within this category and constitute a special service function for Navy management. One such audit is called the Status Audit. Through the use of statistical sampling techniques, specific practices and procedures throughout the Navy are tested and evaluated annually. Such areas as stock record accuracy and backlogs in the matching of documents in stores accounting are reviewed to determine significant trends in improving efficiency of operations. The areas are audited during the same month each year for a minimum of three years or until significant improvement exists.

Another type of audit conducted at the request of an activity is the Management Data Audit. These audits "are designed and conducted in order to ascertain the data required for better management controls, to eliminate unnecessary reporting, and to maximize the use of graphic presentation

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[22]E. D. Stanley Jr., Rear Admiral, SC, USN, "Internal Audit in the Navy," The Armed Forces Comptroller, IX (September, 1964), p. 13.

of data."[23] The establishment of a Management Information Center, similar to the one described in the previous section, is the ultimate purpose of these audits.

Another audit conducted on request is the Personnel Services Audit. Its general purpose is to increase the effectiveness of the various services provided the servicemen and their families while maintaining economies in operations.

This section provides a description of the type of auditing conducted within the Navy. While much of the audit effort is directed toward financial operations within the various categories, an increasing number of areas removed from accountancy, budgeting, and financial reporting are being reviewed for management's benefit. Based on the foregoing, there is sufficient evidence to support the fact that Navy Audit is just as advanced as the commercial firm's audit organization, if not more progressive, in their service to management.

IV. PERSONNEL

Before commencing the main discussion in this section, a review of the Civil Service grade structure for Navy Audit and the number of personnel in each grade is given. Additionally, to provide total manpower perspective, the military ranks and number of personnel in each are provided in Table III:[24]

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[23] Ibid., p. 13.

[24] Nicks, loc. cit.

TABLE III

FIELD OFFICES' PERSONNEL TABULATION

CIVILIAN GRADE	NO.	MILITARY RANK	NO.
GS-15	2	CAPT	10
14	23	CDR	5
13	46	LCDR	4
12	62	LT	10
11	94	LT(jg)	19
9	44		
7	28		
5	7		
	306		48

A few comments concerning the above data are in order. The twenty-five civilians in the GS-14 and 15 grades are, for the most part, Directors and Assistant Directors at the NAAO's. The personnel in the GS-11 through 13 rating are generally supervisors at the various audit sites; the grade of the auditor in charge is dependent on the type of audit involved. The Captains represent the officers in charge of the field activities and the Commanders and Lieutenant Commanders their deputies. The junior officers work in the field as auditors under the supervision of the auditors in charge. This table also represents only the field organizations and does not include AUDGENAV headquarters staff. The following discussion concerning the personnel challenges of Navy Audit is oriented only to the civilian personnel since they constitute the majority of employees.

With the advancement of the internal auditing profession into the management arena, one of its greatest challenges became its own personnel. Heretofore, it had been sufficient to employ accountants, train them in Navy

policies and procedures, and send them on "fidelity" audits. However, these same auditors are currently available to top management for analyzing all operations (except tactical) of the Shore Establishment to determine if resources are being utilized in the most efficient manner. This new requirement confronting the auditor demands that he be knowledgeable in many more areas of the management field than finance. Consequently, the executives of the internal audit organization have, among others, the following responsibilites:

(a) ensuring that these demands are considered when evaluating qualifications in the recruitment process,

(b) ensuring that employees remain abreast of new developments in all phases of management,

(c) ensuring that the promotion process will result in the advancement of the most capable employees in light of these new demands, and

(d) ensuring that career patterns for the employees are such that competency and professionalism are constantly being advanced.

These responsibilities can simply be stated as recruitment, training, promotion, and career development. The purpose of this section is to review current procedures in these areas and to provide suggestions for improvement if required.

The Recruitment Process. Recruitment of auditors is accomplished by the field offices under the guidelines of the Civil Service Commission and Navy Civilian Personnel Instructions. The Civil Service entrance requirements for applicants are stated as "a college degree with an accounting

major or equivalent substitution of experience to assure overall ability to undertake professional accounting and auditing work."[25] The major question is whether these background and experience requirements are commensurate with the objectives and responsibilities of the organization. Internal auditors today evaluate all aspects of management operations, only one part of which is financial, per se. This new trend has changed the objectives, or at least the means to them, of the organization; and yet, their entrance requirements remain unchanged. Additionally, the atmosphere in which the auditor works has been undergoing a transfiguration since 1961. Decisions in the Office of the Secretary of Defense and the Department of the Navy are currently being made with the aid of economic and systems analyses within the framework of the Five-Year Force Structure and Financial Plan. It is of utmost importance that the auditor understand these new management techniques in order that he may better serve the Navy. In view of changing requirements and management techniques, it is questionable whether the internal audit organization should continue to employ only accountants. The benefits to be derived from economists, industrial engineers, data processing personnel, and accountants on the auditing staff appear to be advantageous. Just as one man cannot effectively run an industrial or governmental complex without the aid of staff expertise, neither can the audit organization hope to evaluate management operations with only experienced accountants.

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[25]Ivison, loc. cit.

Although many people would argue against the hiring of employees with diverse backgrounds, the service provided in the years to come by a balanced audit team may very well be improved. It is suggested that serious consideration be given to the employment of qualified personnel from all fields of management.

Training Programs. Any successful organization today has, as part of its personnel development program, what the literature commonly refers to as "training." Most of the policies and procedures established by the Civil Service Commission and/or the Navy set forth required training programs for various agencies and departments. However, most of these training programs are applicable only to blue and white collar workers and are an attempt to bring about proficiency in their respective skills. This type of training is not completely adequate for increasing the caliber of work performed by the audit organization--rather, an increased emphasis on education should be the goal. One differentiation between education and training is as follows:

> EDUCATION is the development of the special and general abilities of the mind (learning to know): a liberal education. TRAINING is practical education (learning to do) or practice, usually under supervision, in some art, trade, or profession: training in art, teacher training.[26]

Training courses, such as the five-week Procurement Course given in the Washington area, are valuable to new employees, but, as one gains

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[26] C. L. Barnhart, The American College Dictionary, (New York: Random House, 1963), p. 383.

on-the-job experience, a broader knowledge of management principles and techniques is necessary. The Navy and the Civil Service Commission set forth policies whereby employees can utilize tuition aid, scholarships, and fellowships as a means of furthering their education. Although these services are provided, only "63% of all Navy auditors hold bachelor degrees and 7% hold advanced degrees."[27] Some method must be found to motivate internal auditors into a program of self-development through education.

The establishment of the Audit Analysis Division, mentioned in Section II, is certainly a step in the right direction. However, it is believed that this program is not enough to keep the audit organization moving forward. Through effective personnel direction and leadership, management can motivate self-development through a suggested educational program, and recognition of advanced education should be made when considering employees for promotion. Caution is required in that the lack of advanced education should not hinder a qualified employees's advancement--this is a negative attitude which could certainly be detrimental to the organization's morale and efficiency. But advanced education could be the deciding factor in choosing between two equally qualified employees, and in this manner it could be helpful as a positive motivator. The high level of service provided to top management today can become even more useful through a positive program of education.

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[27]Ivison, loc. cit.

The Promotion Process. One of the most important functions in personnel management is the selection of employees for advancement. Through this process any organization attempts to channel its best-qualified executives to the top of the pyramid. Two areas for concern in the promotion procedure worthy of comment are the criteria used for selection and the location of the selecting body.

The criteria now used for selection consist primarily of the opinions of the selectors and annual reports of job performance on "performance rating" sheets (NAVEXOS 3238). These rating sheets provide the supervisor or executive the opportunity to rate a subordinate as outstanding, satisfactory, or unsatisfactory in overall performance. There are also spaces for these same ratings in "quality of work," "quantity of work," and "adaptability." The form states that any ratings of outstanding or unsatisfactory require a signed statement by the supervisor as to the reasons thereof. This makes the utilization of these forms as promotion criteria questionable. It is suggested that employees of marginal perfom-ance and those just above satisfactory performance are given ratings of satisfactory to eliminate the need for a written statement. Consequently, a greater-than-accurate majority of personnel will fall within the category of satisfactory with only the totally unfit and exceptionally outstanding people at the ends. When selection for openings occurs, the selection committee may very well be faced with a group of satisfactory applicants, who may, in fact, range from above to below satisfactory. Their decision

could be based only on subjective reasoning and influenced by longevity of the applicants. Since the utilization of these rating forms is optional,[28] it is suggested that the Internal Audit organization devise its own evaluation forms in order to provide more information to selection committees regarding employee qualifications.

As of 1964, Navy Audit was planning to establish a centralized personnel file on all civilian employees in the grade of GS-12 and above.[29] One use of this file would be to provide a selection committee, at AUDGENAV, with pertinent information on each employee for promotion purposes. This proposed plan is highly desirable--for two reasons. First, selection to the next grade places the employee in a supervisory position; therefore, he becomes a member of management within the organization. He is not only responsible for knowing and fulfilling the objectives of the field office, but he must also be responsive to the overall goals of the total organization. It is believed that this centralized selection system would encourage this responsiveness. Secondly, the centralized selection system would facilitate the overall planning of careers, which is discussed next.

The Career Development Program. William L. Campfield, a distinguished auditing executive with the Army Audit Agency, states that:

> Too often, audit organizations are made up of groups of specialists. This tends to narrow the individual staff member's experience so that by the time he has progressed

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[28] Bureau of Naval Personnel, Industrial Relations, (NAVPERS 10793-B, 1964), p. 71.

[29] E. D. Stanley, Rear Admiral, SC, USN, "Internal Auditing in the Navy," The Federal Accountant, XIV (Winter, 1964), p. 56.

> in the organization to where he is a candidate for top management responsibilities it may be too late to give him the broad experience requisite for executive positions.[30]

The Navy's Internal Audit organization must develop a pool of qualified executives who can step into top management positions anywhere in the organization whenever the need arises. The development of these future executives must not be left to chance, or the quality of service to top management of the Navy will deteriorate.

Currently, personnel career and development planning is accomplished at the field offices where the responsibility is that of the "line" supervisors and their managers. Because of pressures and demands on everyday productive effort, it is doubtful whether an organized system of career development is feasible. Even if such a program were in existence, the local office could develop their personnel to fit only local demands or objectives. This could give rise to the suboptimization described previously.

Another characteristic of career development in the audit organization is that of vertical versus horizontal job movement. Except for those people desiring to relocate for personal reasons or as a means of advancement, almost all job rotation is vertical. There is no program for transferring personnel among the various field offices and the Auditor General's Office in order to develop a broad knowledge of how the total organization

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[30]William L. Campfield, "Developing Audit Executives," The Federal Accountant, XIII (March, 1964), p. 104.

operates. For the most part, personnel are hired at a particular location and remain there throughout their careers--even the exceptionally well-qualified people.

A career development program that would develop an individual in terms consistent with the total organization's objectives and give him a broad spectrum of knowledge of the total organization would be facilitated if responsibility for the program were in the Auditor General's Office. Hopefully, the centralized personnel file mentioned previously is a move in this direction.

Another aspect of career development through rotation is that of interdepartmental transfer. As noted in Chapter II, some commercial firms use the audit organization as a training ground for potential executives, financial and otherwise. Any young, potential executive employed in the Comptroller organization of the Navy would benefit immensely from three or four years of service with Navy Audit. The experience and breadth of knowledge acquired during his stay would take him years to obtain elsewhere in the organization. This is not to say that Navy Audit should become a massive training area for other organizations. A permanent core of career auditors are necessary to maintain continuity, but there appear to be advantages in having potential executives utilize the audit organization as a "stepping stone." One is the service provided to the overall management effort of the Navy. In addition to an audit service, the organization would provide an executive development service. The audit organization

would also receive benefits from such a program. It would constantly receive exceptional personnel who would add to the potential service Navy Audit can provide. With the shift to management auditing, these potential executives could stimulate new thinking and creative ideas in the audit process. When these men reach their executive goals, the rapport with which their organization and the audit organization do business would be strengthened.

Table I on page 61 shows that manpower resources constitute the major input to the audit organization. Consequently the output--service to management--is dependent upon the caliber of personnel in the organization. The real value of the audit effort in the future is directly related to audit management's attention to its personnel responsibilities. It is suggested that consideration be given to employment of personnel of diverse management backgrounds, increased attention to the self-improvement of its personnel through higher education, revision of performance rating procedures and forms, and rotation of auditors horizontally in the organization. Additionally, the use of Navy Audit as a training area for young executives is mentioned as an innovation that would benefit both the audit organization and the Navy.

The centralized personnel file system planned for Navy Audit is an encouraging indication of management's awareness of the benefits to be derived from a modernized personnel program. The constant review of personnel policies and procedures with the goal of increasing the caliber

of manpower resources is an absolute necessity if the output of Navy Audit is expected to improve in the future as it has in the past.

V. AUDIT REPORTS

The end product of all audit effort has traditionally been the audit report. The results of all the resources expended by the audit group are found in this report which is the "service provided to management." The purpose of this section is to show the audit reporting process as it existed prior to 1964 and how it has been improved as a means of management information.

Audit Reporting Prior to 1964. The reporting of the conditions, findings, and recommendations resulting from an audit were separated into two reports--informal and formal audit reports. The informal report usually consisted of minor items requiring corrective action within the purview of local commands. These reports were issued by the NAAO directly to the activity audited and thereby relieved AUDGENAV and management control agencies from receiving information of minor importance. It should be mentioned here that all findings and recommendations (major and minor) were discussed with the local command during and at the close of the audit in hopes of reaching agreement on corrective action if within the purview of the command.

The formal audit report consisted of important items requiring the attention of management control agencies and/or items on which local

command and auditors could not reach agreement. The procedures for processing the formal report were as follows:

> (1) the submission to (and discussion with) the commanding officer of the rough preliminary draft of the final formal report at time of completion of the audit largely assuring agreement of the facts at the local level, (2) the official submission by the NAAO of the preliminary draft of the final formal report to the applicable management bureau, copy to the audited activity and the Navy Auditor General, requesting notification to the Auditor General of the Navy within 3 weeks of any instance of non-concurrence with a recommendation or finding, (3) review and final editing of the preliminary draft by the Auditor General in the light of bureau comments, Navy policy, etc., (4) final publication by Navy Auditor General of the audit report, action to the applicable management bureau, (5) management bureau directs and monitors the accomplishment of the audit recommendations, (6) management bureau submits to the Auditor General a report of action taken by a specified date, (7) advice of implementation is reviewed for adequacy in the Office of the Comptroller of the Navy. Correspondence with the bureau or office is continued as necessary until a satisfactory reply has been received in connection with each recommendation.[31]

In commenting on the review of this procedure, a sampling of formal audit reports, and the adverse effects resulting therefrom, the Dillon Report states:

> The lack of timely processing of audit reports tends to reduce their value to management and to reduce the effectiveness of the findings and/or recommendations. . . A sample of twenty formal audit reports issued in 1962 disclosed that on the average, 137 days elapsed between the completion of an audit and its publication in final form. The range was from 63 to 290 days. In the case of the formal audit report recommendations, the "execution"

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[31]Ivison, op. cit., p. 63.

> and "reporting of compliance" phases occupy much additional time. . . Considering the fact that the findings and recommendations have been "checked out" at the local level, it appears that the processing time to point of publication could be reduced. It is apparent that the prescribed procedures are time consuming and processing time might be reduced by changes in such procedures.[32]

The outcome of the Dillon Report was a revision of the audit reporting procedure to provide a more effective and streamlined system of reporting.

Current Reporting System. The Secretary of the Navy issued a directive effective as of March, 1964 to rectify the situation regarding audit reporting found unfavorable by the Dillon Report. The revised system decentralizes the responsibility for "audit utilization" to the local NAAO and command audited. Upon completion of the audit the NAAO submits an "audit package" which consists of:

> (1) a letter of transmittal;
>
> (2) the audit report (enclosure (1) to the letter), including reference to local management programs and actions currently in hand which relate to the areas covered by the audit;
>
> (3) comments on the findings of the audit report (enclosure (2) to the letter) containing the following information:
>
> > (a) an introductory paragraph, where applicable and desired by management, containing information which management considers necessary to provide completeness of context to the audit report,

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[32] Ibid.

(b) a statement of actions taken by management during or after the audit, on the deficiencies noted,

(c) a statement of detailed actions planned by management, with target dates for completion, on findings and/or recommendations within the purview of the commanding officer, and

(d) a statement indicating items unreconciled, including the position of the commanding officer, and those items requiring action by higher authority.[33]

The distribution of the audit package is accomplished by the NAAO and is forwarded immediately to the management control agencies (also agencies having technical direction over an activity and AUDGENAV). Within 40 days, recipients of the audit package must advise AUDGENAV of:

(a) concurrence with audit findings directed to the activity level.

(b) action taken or to be taken on findings and/or recommendations specifically directed to agencies exercising management control and/or technical direction.

(c) items on which exceptions are taken because of conflict with departmental policy or other considerations.[34]

Upon receipt of objections to audit findings and recommendations by AUDGENAV, reconciliation of these items is made and an addendum to the report issued where necessary. The success of this new system is directly related to the effectiveness of local NAAO's and activities

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[33]Secretary of the Navy, Utilization of Activity Audits, (SECNAV Notice 7540, 17 January 1964), p. 3.

[34]Ibid., p. 4.

audited to reach agreements on items within their purview and to set reasonable target dates for implementation of the solutions. The system places the responsibility for audit service on management at the local level; in this manner, a more responsible attitude towards this service will be effected.

Another aspect of the new audit reporting system is Audit Summarization. It is recognized that top management officials of the Navy do not have the time to read and analyze audit reports. Consequently, the Auditor General collects all audit reports completed each quarter, analyzes them to determine trends and important problem areas and summarizes this information for presentation to top management. The information is usually separated into categories according to the management official's area of responsibility. Audit summarization provides top officials with pertinent information, with the least time consumption, that is required to perform their mission effectively.

The current system of audit reporting is an improvement over the former. Not only is the total reporting time shortened, but the responsibility for reaching an agreement on findings and recommendations and ensuring implementation of corrective action has been decentralized to local activities. This decentralization and the audit summarization program frees top management from the tasks of detailed review and correspondence between officials. The whole process has been streamlined so that optimum service is provided.

VI. SUMMARY

In the first part of this chapter, the objectives of Navy Audit are discussed, and it is shown that in 1956 the audit objectives included the review of utilization of resources. Although many would argue about the necessity for resource utilization reviews by auditors, DOD emphatically pointed out the changing trends in auditing during 1960. The current objectives reveal that the auditor delves into all functional areas of a business manager's operations--not just his financial records. The purpose of this operational or management approach to auditing is to provide the most relevant and important information in all aspects of a manager's operations so that his decision making process is improved, and therefore his effectiveness and efficiency.

In regard to organization, the determination is made that the Auditor General reports to a very high level of Navy management--the Assistant Secretary for Financial Management. Because of this relationship, it is concluded that the Auditor General maintains the necessary independence to effectively accomplish his objectives. The internal organization of Navy Audit is spread throughout the world with nine Navy Area Audit Offices responsible for specific geographical areas. Of significant importance is the relatively low cost of operating this organization when compared to total Navy expenditures ($4.2 million to $14.5 billion, or .03%). The recognition of developments in management science and constant review of

the audit resource allocation are indicative of audit management's contemporary viewpoint.

Section III describes the various types of audits: fidelity, activity, cost reduction, servicewide, regional, and special. Table II on page 64 indicates that the fidelity audits comprise only one percent of the total audit effort, while activity audits comprise forty-two percent. Activity audits are scheduled so that all functional areas within an activity's operations are audited once every three years. The amount of manpower utilized in the review of Cost Reduction proposals represents seventeen percent of the audit effort. Since these reviews are verification audits, the effectiveness of allocating this much manpower to such a function is questionable in terms of real service to management. The use of servicewide and regional audits is a recent innovation in Navy Audit. The advantages of reviewing a functional area or program in its totality and examining the interdependencies of its operations are many, one of which is the prevention of suboptimization in the audit resulting in better management information. Some of the special audits discussed are status audits (trends in specific areas through statistical analysis), management data audits (analysis of data required for better management control), and personnel service audits (review of the personal services military men and families receive in the Navy). This section reveals that the areas into which the auditors delve are not limited to financial operations, but include most of the functions performed by a manager.

The personnel section of this chapter indicates that personnel management is of utmost importance since the output of the audit organization is only as good as its employees. Management attention must be directed to personnel programs of recruitment, training and education, promotion, and career development. It is suggested that serious consideration be given to (1) employing personnel with diverse management backgrounds rather than only accountants, (2) increasing emphasis on higher education through a self-improvement program, (3) revising performance rating procedures and forms in order to provide selection committees better information, (4) transferring personnel among the various audit organizations' units to develop broader knowledge, and (5) utilizing Navy Audit as a training ground for potential executives employed elsewhere in the Navy Department. Although efforts are being made to improve the overall personnel program in Navy Audit, challenges still exist in this area that, if met, would increase the caliber of its personnel and, therefore, audit service.

The audit reporting system as it currently exists is a vast improvement over the pre-1964 system. The responsibility for solving the problems and disagreements between the local activity and the auditor has been given to the applicable NAAO. The result of this decentralization process is twofold. One, the local auditor's attitude towards his findings and recommendations may change because he now has to reconcile the items with local management, rather than just write up an audit report and submit

it to AUDGENAV. The difference of attitude may improve the service heretofore provided local management. Two, top management is relieved of reconciling disagreements through correspondence reducing the total time to complete an audit cycle.

Based on the information in this chapter it is concluded that the Navy Audit organization has kept pace with changing times. It has progressed as far, if not farther, than industrial audit organizations in providing top management with important and pertinent information for their use in the decision making process.

CHAPTER V

REVIEW OF AUDIT REPORTS

The thesis of Lieutenant Commander Dick H. Francisco includes a review of thirty-one activity audit reports that contain 330 recommendations. Since this review was done in 1964 and was so extensive, it is thought unnecessary to conduct another extensive review. Rather, six activity and two servicewide audit reports are reviewed to determine the general format of the report and any significant departures from Commander Francisco's findings.

I. FORMAT OF REPORT

The review of activity and servicewide audit reports reveals that they follow basically the same pattern. First, the introduction to the report provides the purpose and scope of the audit and any comments by the local command regarding findings and recommendations. Second, the summary of significant findings or synopsis (in servicewide audit reports) is given. The inclusion of this section at the beginning of the report enables management officials to obtain the most important information without reading the detailed aspects of the report; this gives them the option of obtaining the details. Third, each finding in the report is discussed in detail; generally, the pattern of the detailed discussion is (1) the description of general situation, (2) the specifics of an activity's practices,

(3) the consequences of erroneous or inefficient practices, and (4) the recommendations. Fourth, any exhibits necessary to substantiate the findings are provided and a recapitulation of the findings by cognizant bureau, office, or command. Finally, under the new system of audit reporting, the target dates for corrective action on those items that the local command concurs with are given.

The format of the Navy audit report is very similar to that in industrial use described in Chapter II. Navy Audit has recognized for some time that executives must have the most important information initially, rather than "digging" through a mass of detail. The use of the decentralized corrective action procedure saves top management much time in unnecessary correspondence to field activities.

II. AUDIT FINDINGS

Activity Audits. The six audit reports and thirty-four findings reviewed in the current research reveal two of the problems discussed by Commander Francisco, i.e., matters of an insignificant nature being reported to top management and the inclusion of items under correction by local management. In as much as these problems have been fully discussed, no need exists for further discussion. One significant aspect of the current review of audit reports is the number of findings outside the financial area. Of the thirty-four findings, twenty, or fifty-eight percent, deal with other operations. For example, even in the audit of Cost Accounting, findings

on the efficient utilization of equipment, the effects of unrealistic time standards for repair work, and the establishment of inefficient maintenance policies are reported. These findings are indicative of the changing scope of Navy auditing.

In his thesis, Commander Francisco arrives at the conclusion that a large number of findings in audit reports refer to noncompliance with existing rules, regulations, and policies. He suggests that these findings be reported only to local management, and this would be enough to encourage corrective action. He also suggests that auditing in functional areas rather than taking the management audit approach encourages auditors to look for noncompliance items instead of helping local management. It is suggested that the management approach can be applied even within the functional areas; even more important, exception must be taken to his views on compliance auditing. One of the objectives of internal audit has always been to ensure compliance by operating departments with the established policies and procedures. Before management or the auditor can determine that a policy, procedure, or system is ineffective, assurance that the people operating within its framework are functioning correctly must be made. Only after this can the others be appraised fairly. There is within the Navy a great deal of noncompliance with policy established at higher levels. This is pointed out in the following statement:

> Internal audit reports have cited instances in which material utilization and command performance reports of various types have been erroneous to the degree that they

> are unreliable and can serve only to misinform management. . . . A distressing aspect of these erroneous reports is that the errors work to the benefit of the originator with greater frequency than reasonably can be attributed to chance. . . . One of the principle values of audit. . . is to assist management levels above the activity under audit in ascertaining whether policies and procedures are effective and are being appropriately applied.[1]

The determination of local organization's compliance with top level policy is a very important part of the activity audits. If local management is not accomplishing the tasks it should in the way prescribed by higher levels, the overall goals of the organization will never be met. Top management must make decisions constantly and in doing so must have assurance that field organizations will carry out these decisions efficiently and effectively.

Servicewide Audits. One of the servicewide audits completed by the Navy is the "Selected Phases of the Repairable Aeronautical Material Program of the Naval Aviation Supply System." The purpose of this audit was to evaluate its effectiveness and economy as a supply management operation. In order to accomplish its purpose, the audit covered all management practices in the areas of requirements determination, overhaul and repair, work scheduling, production, and control of inventory assets. The results of the audit reveal a determination of inefficient management

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[1]Secretary of the Navy, Management Attention to Audit Reports, (SECNAV Instruction 7500.6, 29 August 1963), p. 1.

practices that if corrected would amount to $60 million in cost avoidances annually.

The other servicewide audit is entitled "Supply System Responsiveness to Fleet Requirements for Ships Assemblies and Repair Parts." Its purpose was to appraise the procedural worth, effectiveness in practice, and economical management of the ships parts supply distribution, accounting, and reporting systems, with particular emphasis on requirements determination, material management, and system responsiveness. The most significant findings of the audit were the poor quality of stock status and demand information upon which supply and procurement decisions were being made at the inventory control point. Some of the improvements suggested by AUDGENAV are (1) the elimination from centralized management of low demand, commercial type stock items, (2) the consolidation of all centrally managed items into fewer stock points, and (3) the centralization of all recording and related supply decisions under the inventory control point. These and other suggestions are estimated to alleviate annually approximately $48 million in costs now being incurred.

The significance of these two audits is in the approach to the audit. The totality of the systems was examined and this prevented any suboptimization. The magnitude of inefficient policies, procedures, and operations was determinable by reviewing the whole system. These audits show Navy Audit's contemporary thinking in its service to management.

III. SUMMARY

The review of audit reports reveals that they consist of the following sections: (1) the introductive statements of purpose, scope, and local management comments, (2) a summary of significant findings, (3) the body of the report which discusses each finding and provides recommendations, (4) a recap of findings by cognizant bureau, office, or command, and (5) the target dates for those items being corrected by local management. The Navy Audit report format resembles that used by internal audit organizations in industrial firms.

Two conclusions reached in previous research on insignificant findings and corrected situations being reported to top management are also present in the current review of audit reports. One very noticeable point in the current review is the number of findings and recommendations in areas other than financial operations, which substantiates an earlier conclusion on the scope of internal auditing today.

Commander Francisco's conclusion that compliance auditing is too extensive and does not need to be reported to top management is challenged. The top management of the Navy must be assured of field activities' compliance with policies and procedures; if they are not, the system as a whole will never reach the goals established by management. The auditor is in a perfect position to do this, and it should be a part of his responsibility. This does not mean that a management approach to auditing cannot

be achieved; the servicewide audit indicates a management approach to appraisal of various operations or systems. The responsibilities of the Auditor General are many and varied; a "mix" of objectives exist and among them are the compliance feature and the management approach to auditing. Both must be fulfilled to maintain adequate service to management.

CHAPTER VI

SUMMARY AND CONCLUSIONS

The structure of this paper is such that internal auditing in the industrial community and in the Navy are discussed separately. The purpose of this chapter is to bring together the more relevant points of the two situations and to reach a conclusion on the status of Navy Audit in regard to modern day practices in industry.

I. OBJECTIVES

The historical review of internal auditing in private industry reveals that it evolved from the public accounting service provided by external auditors. As expansion and diversification occurred and management found itself separated from day-to-day operations, methods of control beyond the normal internal and management control systems were needed. The conclusion is reached that internal auditing is not part of the aforementioned control systems but a higher level of control which may be referred to as an executive control system. The internal audit function has always been closely associated with the accounting or financial systems of a company. The research shows that today auditors are reviewing and appraising many areas of operations other than financial. This trend to operational or management auditing is an additional responsibility of the internal auditor rather than a replacement for financial auditing. The

objectives of industrial internal auditing are stated as providing a service to management which ensures (1) compliance at all levels with plans, policies, procedures, and internal and management control systems, (2) the feasibility and/or effectiveness of objectives, plans, policies, procedures, control systems, protection and utilization of resources, and capital investments, and (3) that information systems contain accurate and reliable data.

The review of internal auditing in the Navy reveals that it was initially concerned only with accounting operations. However, the 1956 statement of objectives gave the first indication of a trend to other areas of review when it included appraisal of effective utilization of resources as a part of the audit function. The trend to the management auditing was given added impetus in the early sixties when the Secretary of Defense stated that he wanted more emphasis placed on "how the dollar was spent, rather than how it was recorded".[1] The current objectives of Navy Audit as expressed in the Navy Internal Auditors Handbook state that the auditor is concerned with any phase of a manager's operations (except tactical) where he can provide a service. One outstanding example of the management approach to auditing is the servicewide audits completed by AUDGENAV. Each of these covered a whole management system in order to improve management's effectiveness.

As previous research indicates, many findings in activity audits are of the noncompliance nature. Although this is criticized as not providing

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[1]S. H. Ivison, Captain, USN, Review of Management of the Department of the Navy: Financial Management Study, Volume II, Study 7, (NAVEXOS P24268-7, 1962), p. 50.

the best service to local management, a prime responsibility of the auditor is to ensure top management that its policies and procedures are being followed at all levels. Previous writers consider the reporting of noncompliance to top management unnecessary; however, the statements in SECNAV Instruction 7500.6 indicate that local management officials tend to disregard information contained in audit reports. This necessitates the reporting of such items to top management. The manpower used by Navy Audit in verification of cost savings submitted by activities under the Cost Reducation Program represents seventeen percent of the total audit effort. It is suggested that this manpower could be more effectively used if the savings reviewed tended to be correct as submitted. Since the program consumes so many mandays, the benefits derived should be reviewed in relation to the costs expended.

Review of the other types of audits conducted by the Navy reveals that the proportion of manpower spent on fidelity audits is very small. Various special audits are also available for management use, i.e., status, management data, and personnel service audits. The latter two are conducted on request; the former is a statistical sampling of particular practices in the Navy to determine trends in efficiency.

The comparison of the objectives and scope of internal auditing in the Navy and in commercial firms indicates that Navy Audit is providing the same type of service to management as commercial internal audit organizations.

II. ORGANIZATION

The placement of the internal audit organization in industry varies with each firm, but the chief auditor generally reports to the controller. However, the Lamperti-Thurston study reveals that an increasing number of chief auditiors are reporting to an executive of a higher level. The organization of the internal audit unit in private industry is very dependent upon the general size and diversity of the total organization. Consequently, no optimal structure can be determined.

The Auditor General of the Navy reports to the Assistant Secretary of the Navy for Financial Management. Although the latter also acts as Comptroller of the Navy, it is concluded that the independency of the Auditor General is maintained since he reports to a representative of the Secretary of the Navy rather than the Comptroller per se.

The vast complex of the Navy spread throughout the world necessitates a decentralized audit organization. In discharging his responsibilities the Auditor General maintains a headquarters office in Washington, D. C., and nine Navy Area Audit Offices in the United States. The NAAO's are responsible for specific geographical areas and also extend to overseas activities. The total cost of operating this diverse organization represents a small part of total Navy expenditures. The new functions of audit analysis and audit management conducted by AUDGENAV are indicative of the forward management thinking being done in the audit organization. Generally, the

organization of Navy audit is comparable to that of industry, both in relation to the firm as a whole and the audit unit itself.

III. PERSONNEL

The quality of audit service is directly related to the quality of personnel employed by an audit organization. Although the controversy over the employment of men experienced in fields other than accounting has existed for some time, it seems obvious that as the demands of management increase the scope of the auditors' responsibilities the audit unit must have individuals competent in all areas of operation if service is to be of high quality. The Navy has traditionally employed only accountants as auditors. The suggestion is made that hiring personnel with diverse management backgrounds would tend to add balance to the audit effort as well as maintain a high quality of service in nonfinancial areas. Since only sixty-three percent of Navy auditors have bachelor degrees and seven percent advanced degrees, a self-improvement program seems necessary if auditors are going to keep abreast of the latest developments in management theory and practice. The development of the Audit Analysis Division at AUDGENAV to review new management techniques and disseminate information to field offices is a step in this direction. However, the general broadening of knowledge and attitudes to be gained from advanced education seems to warrant further management attention. The centralized personnel file being instituted at AUDGENAV for all auditors in the GS-12 and above

rating is a very significant improvement in personnel management. The selection of auditors for promotion to GS-13 and above by AUDGENAV will permit the top men in the organization to be selected in light of total organizational objectives and guidelines. Discontinuance of the present evaluation sheets and development of an improved system of evaluating personnel to provide selection committees with a more definitive idea of a man's worth are suggested.

The careers of most internal auditors are with one Navy Area Audit Office with very little lateral movement in the audit organization. The rotation of auditors among various NAAO's and AUDGENAV would seem to broaden the individual's knowledge of the total organization, and he would become more responsive to its objectives and plans. The suggestion is also made that Navy Audit be used as a training area for potential civilian executives within the Comptroller organization as well as any other unit in the Navy. The knowledge of the total Shore Establishment operations gained in three or four years with Navy Audit would take many years to obtain elsewhere. The benefits derived from such a program would be twofold: (1) Navy Audit would benefit through the diverse knowledge of these potential executives and (2) the Navy would benefit through this training program for its young executives.

The personnel management program is the Auditor General's most challenging problem in future years. As management policies and techniques become more sophisticated, the assurance of having capable and qualified auditors to meet the demands of top management is very important.

IV. AUDIT REPORTING

Industrial firms realize that the audit report is the end product of the auditor's efforts and as such represents his communication with management. The report should be well organized, including only important items, and free from possible reason for misinterpretation. The closing conference with local management and the inclusion of their comments in the audit report are considered very important parts of the audit process.

The new system of reporting used by the Navy is a vast improvement over the old one. The main reason for this is the reduction of total reporting time due to the decreased correspondence necessary at higher echelons. The decentralization of responsibility to NAAO and local commands to arrive at solutions and set target dates for implementation frees top management from these tasks. Similarly, the Audit Summarization techniques whereby AUDGENAV briefs the secretarial level quarterly on problem areas adds to the efficiency of the whole reporting process. The reporting process within the Navy appears even more efficient than industrial firms with the new decentralized aspect and the summarization process at AUDGENAV.

In the introduction, it is stated that the purpose of this paper is to determine the effectiveness of internal auditing in the Navy as a means of control and to compare its status to that of industry. In view of what is said in preceding chapters, the conclusion is drawn that the internal audit function, as being performed in the Navy, is an efficient means of executive

control and provides a valuable service to management. The policies and procedures utilized by AUDGENAV in fulfilling the responsibilities of the internal audit organization are comparable, if not more advanced, to most industrial internal audit organizations. The conclusion is also drawn that Navy Audit maintains a contemporary outlook in finding better ways to serve management.

The most challenging problem facing the organization in future years is that of personnel management. A progressive program of recruitment, education, and development of personnel in order to meet the demands of top management and to provide the best service is mandatory. For only when Navy Audit has a qualified and balanced team will the United States Navy benefit from its efforts.

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